Market Bulletin
LLOYD'S

FROM:	Tax Manager	EXTN:	6839
DATE:	03 December 2004	REF:	Y3443
SUBJECT:	**INDIVIDUALS: TAX TREATMENT OF LOSSES ON INVESTMENTS IN CORPORATE MEMBERS**		
SUBJECT AREA(S):	INDIVIDUAL MEMBER CONVERSION		
ATTACHMENTS:	Letter from the Inland Revenue dated 12 November 2004		

ACTION POINTS:	**For Information**
DEADLINE(S):	None

The purpose of this bulletin is to provide individuals and their advisors with further information regarding the Inland Revenue's view on the availability of tax relief for losses that may have arisen on shares in or loans to corporate conversion vehicles. This follows on from a market bulletin issued on 19 December 2003 (Y3221).

Background

The 19 December 2003 bulletin attached a letter from the Inland Revenue which raised the possibility that loss relief may not be available for losses on certain investments in corporate conversion vehicles (both Namecos and group conversions). That letter expressed the Inland Revenue's concern that individuals might make claims when the applicable conditions are not met. It also set out the different loss reliefs that might be available to individuals, provided that the relevant conditions are met, to help investors make the appropriate claim or claims.

At the time it wrote that letter the Inland Revenue intended to carry out an examination of the structures of the various conversion schemes and issue more detailed guidelines to the market advising of the circumstances in which individuals would be able to make claims for losses on loans to and shares in conversion vehicles.

Update

The Inland Revenue has now written a further letter to us concerning the application of the loss relief legislation, and this is attached as an appendix to this bulletin. Unfortunately, the guidance it feels able to provide is restricted, as it does not have complete documentation relevant to the various schemes. Whether loss relief is available on any particular investment is therefore dependent upon the facts of each case.

Individuals and their advisors should take note of this and of the Inland Revenue's views in making any claims for losses on investments. For ease of reference, the two extracts from Inland Revenue manuals on the question of penalties that are referred to in its letter are included in the appendix to this bulletin.

Distribution and contacts

This bulletin is being sent to underwriting agents, recognised auditors, personal accountants and individual members who deal with their own tax affairs.

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Date 12 November 2004
Our ref 398/P32/PVM
Your ref

Dear David

Individuals: Tax treatment of losses on investments in corporate members

Richard Rowan wrote to you on 17 December 2003 concerning the statutory requirements for the various tax reliefs that may be available to investors, as shareholders or lenders, in Namecos and collective conversion vehicles. The letter referred to the claims or notices that may be made or given in respect of:

- Capital losses on the disposal of shares in companies (section 16(2A) TCGA 1992)
- Shares that have become of negligible value (section 24(2) TCGA 1992)
- Relief from income tax for an amount of allowable capital gains tax losses (section 574 ICTA 1988)
- Qualifying loans that have become irrecoverable (section 253(3) TCGA 1992).

You attached his letter to a Market Bulletin (ref: Y3221 of 19 December 2003), and we undertook to provide more guidance in due course.

I am sorry it has taken so long to follow up Richard Rowan's letter. Unfortunately we have not received complete documentation for all the conversion schemes, and this restricts the guidance which we can give.

Additionally some prospectuses did include tax advice to investors, but the reasoning leading to that advice was not always provided to us.

I am sure that you will also appreciate that the technical tax issues relating to the conversion schemes are complex and it is therefore in your interests that we only comment where we

are certain that we have been able to fully explore them.

It must also be borne in mind that the facts of each investor's case may differ, and nothing I say in this letter should be taken as determining whether or not the Revenue will enquire into claims made in particular cases. Investors will no doubt wish to consider taking professional advice before formulating a claim.

Subject to these caveats, I thought it might be helpful to set out the Inland Revenue's further views on the tax treatment of losses on investments in Namecos and collective conversion vehicles.

Shares in Namecos and collective conversion vehicles

In most cases shares in Namecos and collective conversion vehicles were issued in consideration of cash and/or the transfer of syndicate capacity to the company but the value of such shares will not necessarily equate with the consideration given for them.

A capital gains tax loss might arise on disposal of the shares (including a disposal where there is a claim that shares have become of negligible value). Subject to the facts of each case, and subject to the conditions of each section being satisfied, claims may be made or notices given under one or more of section 16(2A) TCGA 1992, section 24(2) TCGA 1992 and section 574 ICTA 1988. For claims under section 574 it should also be noted that no relief is available for shares issued after 5 April 1998 in a company carrying on an insurance business.

As emphasised in our letter of 17 December 2003, a claim under section 24(2) TCGA 1992 requires the shares to have <u>become</u> of negligible value. Shares that were already of negligible value at the time of acquisition (for example, where the conversion vehicle was loss making) will not normally qualify. The efficacy of any such claims will depend therefore on the facts of each case.

Loans to Namecos

Under the normal "interavailability" arrangements, where the Nameco suffers underwriting losses, amounts may be drawn down from the Name's Funds at Lloyd's to meet those losses.

Again, the facts and circumstances of each case may differ, but on the basis of the information currently available to us, we take the view that entering into a deed of interavailability, under which the Name's trustees can apply part of the Name's fund to meet the Nameco's liabilities, does not of itself constitute making a loan or advancing money to the Nameco.

In any case where an investor does actually make a loan to a Nameco, section 253 requires the money loaned to have been used by the borrower wholly for the purposes of the borrower's trade. The loan must also have become irrecoverable. A loan which was already irrecoverable when made cannot subsequently become irrecoverable and so will not satisfy the requirements of a claim under section 253(3).

Whether or not at any point in time a loan is irrecoverable depends on the facts of each case and does not rest simply on the ability of the borrower to effect immediate repayment. However, if money were loaned only as a last resort to enable the Nameco to settle its liabilities, this could point to the loan being already irrecoverable at the date it was made.

Loan stock in collective conversion vehicles

The collective conversion schemes under which Names have converted were all different, and again the point must be made that the tax treatment in each case will depend on its facts.

The initial subscription shares in such schemes where the participator has to subscribe are likely to have value when acquired and can become of negligible value.

The treatment of what in some schemes is referred to as 'nil paid convertible unsecured loan stock', is less clear. In such cases, it appears that no debt is actually incurred when the 'loan stock' is issued, no interest is payable, and immediately the 'loan stock' is paid up it is converted into shares.

In some cases, there may be doubt as to whether this really is a type of debt instrument at all. It may, for example, be an option granted to the holder of the 'loan stock' that allows the holder to require the company to issue shares, coupled with an obligation on the holder to subscribe for any remaining balance of the shares not previously issued when required to do so by the company.

In any case where company 'loan stock' really is exchanged for shares, the position will depend on whether the conversion of securities provisions of section 132 TCGA 1992 apply when the loan stock is converted into shares.

If section 132 TCGA 1992 does apply the shares will be treated as having been acquired when the debt was acquired, so the cost of the shares will be the same as the cost of the debt. A negligible value claim under section 24(2) TCGA 1992 will be possible provided the debt was valuable when it was incurred.

However, no claim can be made under section 574 ICTA 1988, since no section 574 claim would have been possible in respect of the original asset, that is, the loan stock. Relief under section 574 ICTA 1988 is due, among other conditions, only on the disposal by an individual of shares. The definition of 'shares' in this section does not include loan stock (section 576(5)).

If section 132 TCGA 1992 does not apply then the cost of the shares for capital gains purposes will be the market value of the asset given in exchange for the shares. That asset would be the debt due to the holder of the loan stock. The market value of a debt will not, of course, necessarily be the same as the nominal value of the debt.

From the claims we have received so far, we believe that that the rules in section 132 TCGA 1992 will generally be applicable where there are conversion schemes involving convertible loan stock.

This is subject to the question of whether in particular schemes it is in fact loan stock and not some kind of option. We will ask Names who believe that section 132 does not apply to supply arguments in support of their claims.

In the case of the **Greenwich** conversion scheme, the Revenue has accepted that the shares were of negligible value as at November 2002. We accept that a capital loss (under section 24(2) TCGA 1992) will arise to many of the Greenwich shareholders. The loss will, in most cases, be based on the difference between the value of their investment on conversion and the date on which negligible value was agreed. As explained above, our view is that no claim is possible under section 574 ICTA 1988.
In the case of the **Stace Barr Angerstein** conversion scheme, the Revenue has accepted that the ordinary and conversion shares in this scheme were of negligible value as at

December 2002. A capital loss (under section 24(2) TCGA 1992) will arise, as for the Greenwich shareholders. We will also accept that an income tax loss under section 574 ICTA 1988 may arise, subject to all the conditions of that section being met. This is because ordinary and conversion shares, rather than convertible loan stock, were subscribed for at the outset.

Interest and penalties

I understand that there have been some queries about Richard Rowan's reference to interest and penalties in respect of incorrect claims.

The comment was merely an attempt to advise claimants on the possible consequences of an incorrect claim. I do not think I can usefully add to what is said in the Inland Revenue's published guidance this matter. Please refer to www.inlandrevenue.gov.uk then go to the 'Practitioner zone', 'Manuals', then 'Enquiry Manual', in particular paragraphs 4802 and 5125. Whether a claim that subsequently proved to be incorrect was made negligently would be considered in the light of its own facts.

I am sorry that I cannot give a clear-cut answer to the question of whether individuals will be able to make the various claims referred to in this letter. I hope the information in this letter will help investors the background to the technical issues, and to decide whether or not they should make a claim.

Yours sincerely

Peter Magee
W Yorks Personal Tax Unit (CPR Team)

EXTRACTS FROM INLAND REVENUE ENQUIRY MANUAL

EM4802 - Penalties: Incorrect Returns, Accounts etc: Approach

The taxpayer is responsible for the accuracy of his/her return. If a return is incorrect, you should find out the reason for the error to establish whether or not the return was submitted fraudulently or negligently EM5100+. You can seek a penalty in a negotiated settlement only where culpability is established or accepted.

It will normally be straightforward to establish that SAI details or accounts which understate the receipts or overstate the deductions have been prepared at least negligently (and any material discrepancies should be apparent to the taxpayer) or have been based on records which have been kept at least negligently.

For SA years, a person can amend their return. That amendment can be made at any time before the end of the period of 12 months beginning with the filing date. But penalties can still apply if it can be shown that the original return was submitted fraudulently or negligently.

Every person served with a statutory return form is under an obligation to supply the particulars required by the form and is supplied with notes which are intended to assist in the completion of the form. Similarly, every person given the opportunity to complete a non-statutory return form receives explanatory notes. Each return must be certified by the taxpayer to be correct and complete to the best of their knowledge. The taxpayer is clearly under an obligation to take the necessary trouble to read carefully both the form and the notes.

If, then, the taxpayer omits certain items of income or understates any income, by more than can be accounted for by genuine errors or honest misunderstanding, it can be said (except in the case of a very ignorant or simple-minded person) that the taxpayer in question could not have had an honest belief in the truth or accuracy of the return and must be guilty of at least negligence.

The taxpayer cannot delegate responsibility for their returns and must to sign them personally. A plea that errors or omissions are due to poor work by an accountant should normally be rejected and the taxpayer should be asked why an incorrect return was signed and what checks were applied personally. The choice of an incompetent accountant may be deliberate and may indicate an intention to deceive both the accountant and the Revenue

EM5125 - Penalties: Culpability: Neglect, Negligence and Negligent Conduct

The terms are interchangeable.

Before repeal by FA89, there was a definition of neglect in TMA70/S118 (1).

'Neglect means negligence or a failure to give any notice, make any return or to produce or furnish any document or other information required by or under the Taxes Acts.'

Negligence has been defined as '... the omission to do something which a prudent and reasonable man would do.' (Baron Alderson in Blyth v Birmingham Waterworks Co, 1856, 11 Ex 781, p784, which was concerned with the law of tort).

We can assume that a reasonable man would, amongst other things

- comply with the requirements of the law by, for example, notifying his chargeability
- make, promptly, a complete and correct return of his income and gains when required to do so under statutory authority
- keep such records as are necessary to enable him to make accurate returns or prepare accurate accounts
- read carefully the notes supplied with the return form, so far as they affect his own circumstances
- seek professional help with matters, such as the preparation of accounts, which he is unable to cope with satisfactorily himself.