



The Actuarial Profession

making financial sense of the future

consultation response

**HM Revenue & Customs – Invitation to comment on Taxation
of Life Assurance Companies consultative document**

Comments from the Actuarial Profession

September 2007

To: **HMRC**

Date: **12 September 2007**

From: **The Faculty and Institute of Actuaries Tax
Working Party**

Copies: **Faculty and Institute of Actuaries Life Board**

Response to consultation by HMRC on taxation of life assurance companies

Background

- 1** The Faculty and Institute of Actuaries Tax Working Party has prepared the following submission to HMRC following consultation with the Life Board of the Faculty and Institute of Actuaries.
- 2** The submission was initiated by the consultation document issued by HMRC in May 2006 on the subject of taxation of life assurance companies. Although the closing date for submissions has expired, we also note that there has been a subsequent request from Jeremy Tyler in an e-mail dated 22 December 2006 entitled “(1) Gaps in HMRC understanding (2) And finally...” which extended an open invitation to submissions commenting on the taxation of life assurance companies. This submission is a response to the later e-mail. Further, we understand that a number of issues raised by the consultation are still under development and so this submission may assist with that ongoing consultation.
- 3** The Actuarial profession has not normally contributed to such discussions as they tend to be focused on specific clauses in legislation and this is probably outside the profession’s area of expertise. However Jeremy Tyler’s e-mail clearly indicated a desire for a better understanding of issues faced by the insurance industry so this note considers some of the objectives of the taxation approach and the implications of the huge developments in financial reporting and management of life companies. These developments may provide an opportunity to remove a number of the artificial features of the current taxation approach and the likely distorting effect on profitability. Such a move may also have benefit for the actuarial profession since these distorting effects are difficult to model and defy intuitive understanding.
- 4** In relation to the May 2006 consultation document, we would add that we are broadly supportive of the objectives of that consultation.
- 5** A Glossary is appended to this paper.

Summary

- 6** The comments in this note may be summarised as follows:
 - We suggest that the allocation of income between tax categories could better reflect the actual allocation used to determine policyholder benefits. We set out below some high level comments on how recent developments should facilitate this approach.
 - We would encourage all activity to simplify the tax legislation which has recently suffered from a number of complex anti avoidance measures and also contains obscure features that can have non intuitive tax consequences.

Allocation of investment income between the various tax categories - background

- 7** For some considerable time, the approach to the inclusion of income (including gains) in the tax calculation has required the apportionment of income between tax categories using mean mathematical reserves for the apportioning. Recently, changes have been introduced to increase the investment income allocated to BLAGAB. However, this whole approach is necessarily approximate and in most, probably all, cases is inconsistent with the allocation of income for the purposes of bonus allocations.
- 8** The May 2006 consultation over the allocation of investment income between tax categories has focused on achieving an effective taxation of 100% of the investment income and on effectively taxing income on assets in long term funds attributed to shareholders on a received basis (as for BLAGAB). It is perhaps surprising that the current regime omits some investment returns from a tax charge for some companies and double taxes investment returns in other companies.
- 9** Additionally this allocation approach leads to taxation treatment of income being inconsistent with benefits paid to policyholders. The reasons include:
- Income is allocated, for tax purposes, in proportion to regulatory reserves and this is currently the continuing expectation subject to some superficial modification. However, with-profits policies with high guarantees may have relatively high regulatory reserves and with-profits policies with comparatively modest or no guarantees will be under represented in this approach. Consequently, the current income allocation reflects the degree of policy guarantee rather than an assessment of the asset value that is attributable to a with-profits policy.
 - Within a reasonably large long term fund there is likely to be extensive hypothecation of assets to groups of policies and the complexity of such hypothecation is likely to continue to develop. For with-profits business, investment income on these hypothecated assets will be used to roll up a form of shadow account that is used to determine bonuses, and ultimately, policy payouts. Such shadow accounts are likely to be specific to particular policy or product groupings and amounts of loan relationship assets and equity type assets will vary between accounts. Hence the allocation of capital gains, loan relationship income and dividend income are likely to differ markedly from that assumed in the current tax apportionment rules (where there is no recognition of this differential hypothecation). A particular example would be pension annuities in a with-profits fund where the hypothecation would be 100% loan relationship assets whereas the current allocation rules would inappropriately allocate equity assets that may be hypothecated to BLAGAB with-profits business, with a compensating misallocation of loan relationship assets and hence taxable income to the BLAGAB business.
- 10** The current system has encouraged companies to establish subsidiaries to write certain lines of business where otherwise the allocation of investment income would be unrealistic. This gives rise to substantial additional governance-type expenses. Furthermore, this solution is not generally feasible for with-profits business because of the difficulty and undesirability of determining a “one-off” apportionment of the fund’s free assets.
- 11** Although not necessarily relevant, it is interesting to note that the current income allocation for tax purposes necessitates two asset allocation calculations, one for modelling tax charges and one for modelling the accumulation of the shadow accounts. This significantly increases

run times for the stochastic models used to calculate the “realistic balance sheet” results and also requires the calculation of regulatory liabilities which are not otherwise required for the realistic balance sheet results.

- 12 Income allocation for unit linked business is consistent with the allocation used to determine policy benefit and income attributable to other non profit business could follow the hypothecation approach suggested for with-profits business.

Allocation of investment income between the various tax categories - suggestion

- 13 We would suggest that the method of allocation of income used by each company for bonus declaration purposes on its with-profits business should be used as an alternative and simpler approach to the current apportionment rules required by tax legislation.
- 14 This would effectively tax BLAGAB business on the income less expenses as allocated to policyholders in the policy benefit payments and that investment income on gross roll-up business should remain untaxed to the extent to which it is ultimately paid to gross roll-up policyholders. This would seem to be an appropriate approach for the taxation of life assurance business for HMRC.
- 15 It is now likely that there are significant controls around this process because companies are required to report on the success with which payouts on with-profits business reflect the policy share of the shadow account. This report is provided annually by the with-profits actuary and is required by the FSA’s conduct of business rules. Further the determination of the “realistic balance sheet” result published in the FSA Returns (which use the shadow account approach) is subject to audit and the opinion of an independent “reviewing actuary”. The governance requirements to enable this reporting and other recent industry developments has lead to the development of significant sophistication in the allocation of investment returns within many life companies and it would seem appropriate to use this functionality for tax purposes.
- 16 This approach would also logically extend to income that relates to provisions for all non profit liabilities and provisions for policy options and guarantees. All such provisions will also be allocated matching assets for the purposes of allocating income across the business of the long term business fund(s).
- 17 The allocation of management expenses between BLAGAB and gross roll-up business is already permitted on a best view basis subject to scrutiny by tax inspectors. It would seem likely that a similar approach could be used for the allocation of investment income. Further, this approach could be structured to achieve the desired taxation of 100% of investment income.
- 18 Again, although not strictly relevant, the use of this hypothecation in the allocation of investment returns for tax purposes would be beneficial in the modelling environment. The shadow account approach to the hypothecation of assets is already modelled in the stochastic modelling in order to ensure that the modelled policy payments are materially correct. The tax calculations already assumed for roll up of these shadow accounts would become appropriate for the main company level calculation of tax without the need for extensive additional and complex modelling.
- 19 The above description of the allocation of income for bonus purposes would be reasonable for most of the larger life companies that report on a realistic basis to the FSA. However, for a number of smaller companies and Friendly Societies that have with-profits liabilities of

less than £500 million, such functionality is not required and may not exist. Hence it would be appropriate to provide for such cases. This is already reflected in FSA Rules whereby such companies are excused the onerous “realistic basis” reporting requirements, subject to adequate demonstration of capital adequacy. It should be possible to develop a similar approach for tax purposes for these companies; presumably allowing a move to an approach consistent with the above discussion or permitting retention on the existing system for companies with less with-profits business.

- 20** Companies that have only non profit and unit linked business should have no issues in relation to their unit linked business. Taxation of their non linked business may benefit from using a similar approach to with-profits business to reflect the likely rigorous controls over the matching of assets and liabilities.
- 21** We note that there is also ongoing consultation on the taxation of income from assets representing inherited estates and on income from other assets held in excess of liabilities within long term business funds. We would expect the taxation of such income to require suitable apportionment although, if the above suggestion is adopted, the amount of such excess assets would logically relate to the liabilities as determined using the shadow accounts and the related provisions for policy guarantees and options.

Reduce complexity and increase certainty.

- 22** Simplifications of the tax regime and removal of esoteric taxation features are to be welcomed and encouraged. Complexity and non intuitive tax rules are likely to expose the industry to risk of errors in both actions taken and financial reporting.
- 23** Further, we would suggest that tax rules should not adversely influence the prudent and appropriate financial management of life assurance business.
- 24** We would accept that companies should seek specialist tax advice for actual transactions, but it would be inappropriate to expect routine modelling for financial reporting to anticipate illogical tax features that may occur in for example modelling of stressed conditions (required for capital adequacy assessment).
- 25** There have been examples in recent years whereby legislative changes have targeted perceived abuse but have had wider implications.
- 26** Consequently we welcome the initiatives in the May 2006 consultation document that seek to reduce complexity though we would also suggest that future consultation is sufficiently broad that all implications of legislative changes are identified. To this end we also welcome the recently introduced practice of providing helpful and clear explanatory notes with draft new legislation and would suggest that this practice is comprehensively applied.

The Faculty and Institute of Actuaries Tax Working Party

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Glossary

Term or Acronym	Description
BLAGAB	Basic life assurance and general annuity business. This is a category of business defined in the taxes acts and includes mortgage endowment business, term assurances and purchase life annuities.
Gross roll-up business	The tax category introduced by the 2007 Finance Act amalgamating the tax categories of pension business, OLAB (overseas life assurance business), LRB (life reassurance business), ISA and Child Trust Fund.
“Realistic” valuation or results	The phrase “realistic” refers to the use in FSA Rules in relation to the “realistic” valuation of with-profits life business, whereby long term liabilities are determined in relation to asset shares plus any associated guarantee costs, typically involving the use of stochastic modelling. The realistic capital assessment may be referred to as the Peak 2 capital assessment.
“Regulatory” valuation or results	The phrase “regulatory” refers to the use in FSA Rules in relation to the regulatory valuation of both with-profits and non-profit life business, whereby long term liabilities are determined by discounting future liabilities at a specified rate of interest. The regulatory capital assessment may be referred to as the Peak 1 capital assessment. This is the approach to actuarial valuations that has been used historically although there have been changes to the detail of the approach over time.
Reviewing actuary	The reviewing actuary makes a private report to a firm’s external auditors on the valuation results presented in the FSA Returns. The management of shadow accounts would be within scope of this report since the values of shadow accounts are material to the realistic valuation results.
Shadow account (referred to as “asset shares” by the actuarial profession)	A notional account consisting of the accumulation value of premiums less expenses and costs, accumulated at the rate of investment return (net of tax) earned by the relevant fund or part fund managed by the life company. Typically each life company describes the rules that it applies to the calculation of asset shares in the Principles and Practices for Financial Management (PPFM) that it is required to publish.
With-profits actuary	The with-profits actuary is required under FSA Rules to advise a firm’s management in relation to the exercise of discretion and the fair treatment of policyholders. This would include assessing the management of shadow accounts in accordance with the PPFM. The with-profits actuary would expect to report, to policyholders, any material failures in PPFM compliance.
