Institute
and Faculty
of Actuaries

The new UK life tax regime

Paul Turnbull
Matthew Taylor

11 November 2013

Agenda

- New Life tax regime
- Tax in financial and regulatory reporting
- Loan relationships and derivatives
- Questions

Institute
and Faculty
of Actuaries

New life tax regime

11 November 2013

New life tax regime

- Principal features
- I minus E computation
- Shareholders’ trading profits
- Trade profit computation
- I minus E and trade profit comparisons
- Impact of basis changes on companies
- Long-term business fixed capital
- Legacies of transition
- Rates of tax
- “Snagging” list
- Emerging practical issues

Institute
and Faculty
of Actuaries

11 November 2013

Page 4

Principal features

Change

- Basis of taxation
  - trading profits
  - merging PHI and GRB
- Treatment of protection
- Allocations (income, gains, profits)
- Blocks of assets subject to chargeable gains
- Part VII transfers

Remain the same

- I minus E
- Minimum Profits test
- Restrictions on losses

Transition

- Differences between FSA Returns and financial statements
- 10 year spreading

Institute and Faculty of Actuaries

I minus E computation

BLAGAB

Investment income	X
Chargeable gains	X
Other income	X
Expenses	(X)
I minus E Profit	X

From 1 January 2013 BLAGAB only - no GRB profit

Institute and Faculty of Actuaries

Shareholders' trading profit

- Two computations of trade profits for non-mutual life assurance business
- Profit means taxable profit driven by accounting profit
- BLAGAB trade profit is not assessed to tax but serves two purposes:
  - To test whether there are excess adjusted life assurance trade profits resulting in a further I minus E tax charge
  - To determine the rates of tax applying to the I minus E taxable profit
- Non-BLAGAB trade profit is assessed directly to tax

Institute and Faculty of Actuaries

Trade profit computation

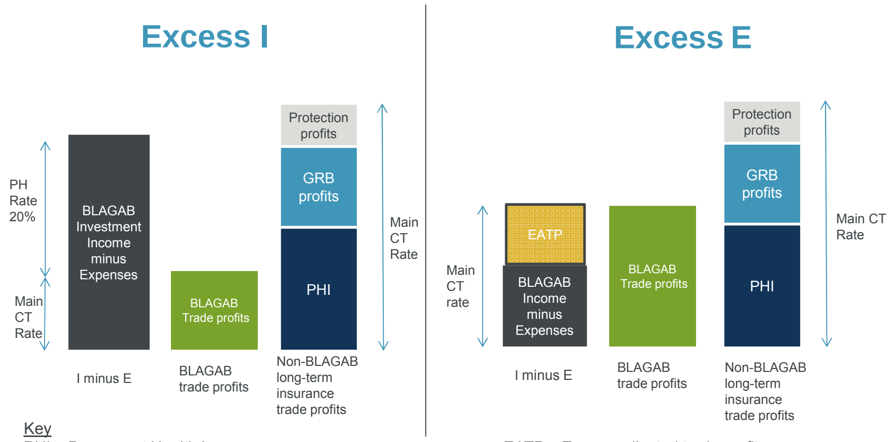
Separately for BLAGAB and non-BLAGAB

Profit before tax from income statement	X
Taxable items in OCI (Other Comprehensive Income)	X
Taxable items taken to reserves	X
Policyholder tax	(X)
Capital allowances	(X)
Disallowed expenses	X
Trade profit	X

Increases in provisions for terminal bonuses, bonuses declared and movements in UDS – FFA are deductible.

Institute and Faculty of Actuaries

I minus E and trade profits comparisons



Key
PHI – Permanent Health Insurance
GRB – Gross roll-up business
BLAGAB – Basic Life Assurance and General Annuity Business
EATP – Excess adjusted trade profit
CT – Corporation Tax
PH – Policyholder tax

Institute and Faculty of Actuaries

Impact of basis changes on companies

- No protection expenses in I minus E
- Protection profits not in I minus E so do not reduce policyholder tax
- Merging PHI and GRB enables PHI losses to be offset against GRB profits and vice versa
- No transitional “streaming” rules so existing losses can be offset against profits from either source
- Beneficial for solo firms as may enable additional access to or acceleration of relief on losses
- Could be bad for groups as losses in other companies can currently be group relieved against PHI profits

Loss relief pattern different

Institute and Faculty of Actuaries

Long-term business fixed capital

- Return on assets and associated outgo will be dealt with as being on trading or on capital account from first principles, i.e. by reference to whether the assets were part of the trade or held as fixed assets to facilitate it.
- A life company could hold a pool of investments separate from the trade assets as an ancillary investment business but which would not normally qualify as "fixed assets". Such a pool could be included with long-term business fixed capital.

Potential loss of realisations basis for shareholder fund equities

Institute and Faculty of Actuaries

11 November 2013 Page 11

Legacies of transition

- Exceptional profit items arising from the transition are spread over 10 years by adding one tenth to trade profits in each of the tax years 2013 to 2022
- Amortisation of excluded items such as DAC, VIF and DIR in the balance sheet at 31 December 2012 is disallowed
- Shareholder fund assets at 31 December 2012 are grandfathered to long-term business fixed capital
- In order to determine transitional adjustments companies will have developed a tool to reconcile FSA returns with financial statements which could be used each year

Institute and Faculty of Actuaries

11 November 2013 Page 12

Rates of tax

- Finance Act 2013 received Royal Assent in July 2013
- The Shareholder tax rate is equal to the main rates of corporation tax that are now enacted as follows:
  - 1 April 2013 – 31 March 2014 23%
  - 1 April 2014 – 31 March 2015 21%
  - 1 April 2015 – 31 March 2016 20%
- The Policyholder tax rate is equal to the basic rate of income tax of 20% in all years

Institute and Faculty of Actuaries

"Snagging" list

- Taxation of reinsurance
  - What is BLAGAB and non-BLAGAB?
  - Imputation of investment return
- Transfers of business
  - Interaction with items excluded on transition
  - Interaction with policyholder deferred tax
- Relief for intangible asset depreciation
- Interaction of loan relationship deficits and minimum profits test
- Consistency of definitions
- Impact of small third party transfers on transitional amount run-off

Institute and Faculty of Actuaries

Emerging practical issues

Commercial allocation

- Approach developed and agreed with HMRC for income gains and profits
- Were premiums, claims and expenses commercially allocated previously?
- Is all the required data available at the right time from the general ledger or sub-ledgers?

Planning

- Managing IFRS / GAAP profits becomes more important than managing regulatory profits
- Taxable profits may be more volatile
- Are there projections of accounting profits?

Institute and Faculty of Actuaries

Institute and Faculty of Actuaries

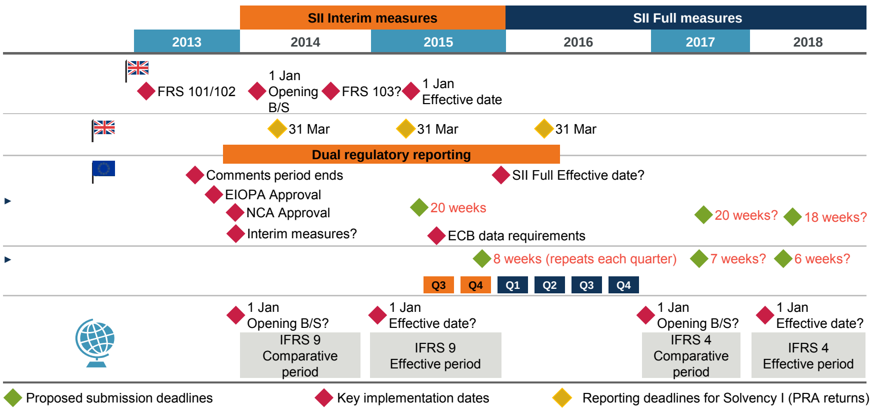
Tax in financial and regulatory reporting

Tax in financial and regulatory reporting

- Timetables
- Transitions
- Tax in technical provisions
- Tax in UK GAAP profit and loss
- Tax in Solvency II - reprise

Institute and Faculty of Actuaries

Timetables - financial and regulatory



Notes:
1. The guidelines for the interim measures do not currently require annual reporting for 2015 year end,
2. The above SII due dates are based on solo reporting. There is an extension for the Group Level Reporting of 6 weeks.
3. Post full implementation of SII, we can expect an acceleration of the deadlines over time. The actual deadlines could even be more aggressive that those in the above illustration.
4. For IFRS 4 Phase II, some data will be required from inception of contract for the purpose of the transition.

Institute and Faculty of Actuaries

How many transitions?

How will life insurers that currently rely on FSA mathematical reserves calculate technical provisions in their financial statements if Solvency II precedes IFRS Phase II?

IFRS reporters:
1. Continue with current (Solvency I) method
2. Early adopt IFRS Phase II
3. Use Solvency II
4. Adopt some part of IFRS Phase II
5. Amended Solvency II

UK GAAP reporters:
1. Move to FRS 102 and 103
2. FRC to consider amendments when Solvency II and/or IFRS phase II take effect

The tax basis for life assurance in the UK has already changed from Solvency I to IFRS 4 or UK GAAP. It will change again as accounting standards are updated

Institute and Faculty of Actuaries

Tax in technical provisions

UK GAAP

- Retains modified statutory solvency basis
- Statutory reserves include value of future margins including tax charges and credits
- “Gross” valuation permitted for excess expenses
- Reference to deferred tax on gains and losses remaining in the technical provision for linked liabilities

IFRS Phase II

- New basis of measurement developed
- Provisions include tax obligations incurred by the policyholder paid by the insurer in a fiduciary capacity and amounts the insurer expects to receive from the policyholder related to them
- Provisions exclude income tax payments that do not arise directly from existing insurance contracts or that cannot be attributed to them on a reasonable or consistent basis

Income tax standards cannot be used until income gains and expenses are themselves recognised

Institute and Faculty of Actuaries

Illustration

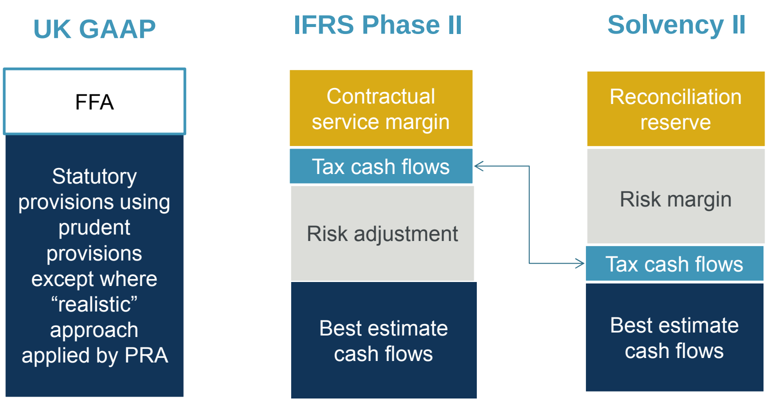


Diagram assumes no investment contracts and that risk adjustment and risk margin are equal

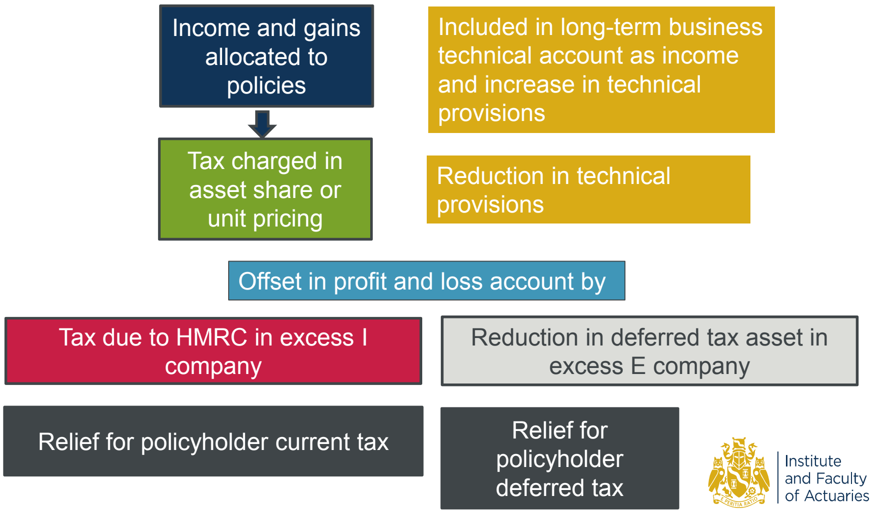
Institute and Faculty of Actuaries

Technical provisions

Issue	Commentary
Deferred tax on unrealised gains and losses	Requiring this to be disclosed as deferred tax and not included in technical provisions will give rise to a profit from a reduction in technical provisions but a deduction for the deferred tax liability. The net impact will be the removal of any discount.
Valuation differences	The impact of valuation differences has traditionally been subject to spreading in life assurance trade profits
Subsequent changes, e.g., release of future profits and recognition of residual margin	If UK GAAP adopts Solvency II liabilities or adapts to IFRS Phase II, future profits would emerge in the first instance but would fall into the residual margin on the second

Institute and Faculty of Actuaries

Matching of profits and tax



Institute and Faculty of Actuaries

11 November 2013 Page 23

UK GAAP Profit and loss account presentation

Issue

- What goes into the long-term business technical account?
  - Coterminous with long-term fund?
  - Coterminous with aggregate of BLAGAB and non-BLAGAB trade?
  - Use of long-term rate of investment return permitted by FRS 103 (IG 2.64)
- What goes into the non-technical account?
  - Coterminous with shareholder fund?
  - Coterminous with long-term business fixed capital ?

Approach

- FRS 102 paragraph 29.22 requires tax to be charged or credited where the related transaction is reported
- FRS 103 (IG 2.70) requires tax on reallocated investment return also to be reallocated
- Tax relating to the transfer follows this approach

Institute and Faculty of Actuaries

11 November 2013 Page 24

Why tax is important in Solvency II

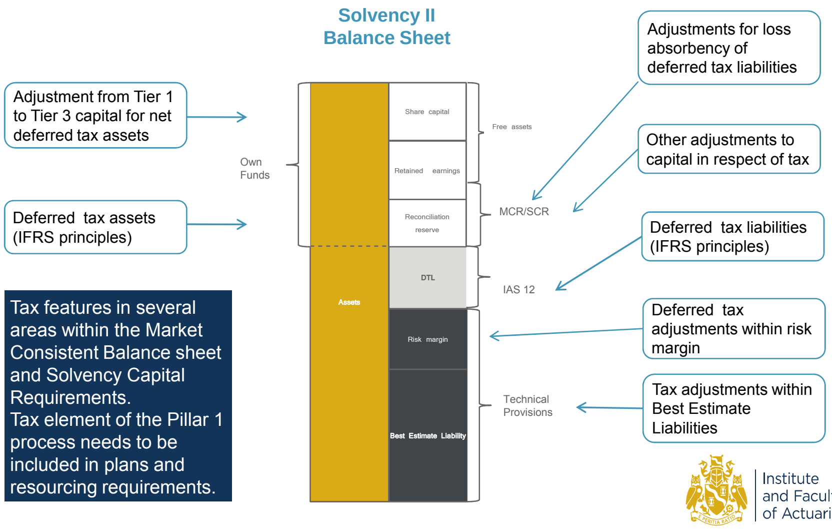
- Tax can constitute a major component of the Pillar 1 calculations under Solvency II:
  - Deferred tax can be a significant balance sheet item in the economic balance sheet, which determines the available capital,
  - The adjustment for loss absorbency of deferred tax liabilities can be as much as 20% of required capital in the calculations of solvency capital requirements both under the standard formulae and in the internal models,;
  - Deferred tax assets comprised over 50% of Tier 3 capital in the QIS 5 results
- Tax risk is an important factor in Pillar 2
- Tax needs to be reported in QRTs under Pillar 3

Institute and Faculty of Actuaries

11 November 2013

Page 25

Where tax fits into Pillar I



Tax features in several areas within the Market Consistent Balance sheet and Solvency Capital Requirements.
Tax element of the Pillar 1 process needs to be included in plans and resourcing requirements.

Institute and Faculty of Actuaries

11 November 2013

Page 26

Key Pillar II tax issues

Identification and governance	Is tax integral to risk models and scenario planning? Is tax on the board room agenda? Does overall risk governance include tax risk governance? Are board packs and risk management information adequately capturing and reporting tax risks?
"Appetite" for tax risk	Is tax risk appetite aligned to enterprise risk strategy? Is quantification of risk limits post tax?
Tax integration	Is tax treated as a separate business function or integrated across the wider business? What level of assurance do risk management and internal audit functions provide over tax risk?
Tax impact	Is tax risk incorporated in the Pillar I supporting documentation? Is the chart of accounts tax sensitised? What assurance can be put in place to evidence that controls re. key tax risks are embedded and effective? Anticipation of impact of tax legislation changes over the business planning horizon
Contribution to the ORSA	Is Tax embedded in the Enterprise Risk Management Framework and ORSA report?
Outsourcing	Does governance of 3rd party relationships adequately manage risks around tax data/compliance and tax sensitive financial information?

Institute and Faculty of Actuaries

11 November 2013

Page 27

Impact on tax reporting

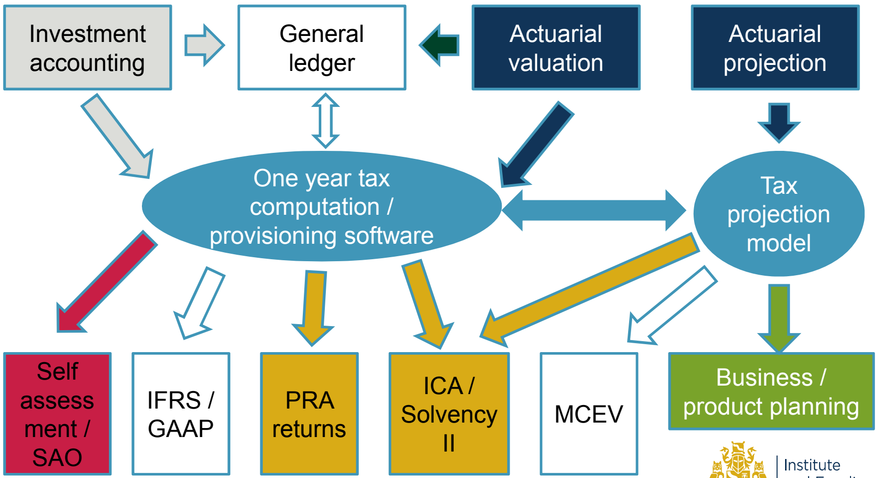
Production of deferred tax numbers in MCBS	Process and timetable needs to be built for production of deferred tax Solvency II balance sheet numbers. These will need to be reconciled between periods and potentially with IFRS as an additional control.
Regular tax review of internal model	Assumptions and inputs into the internal model will require regular monitoring to ensure final numbers are materially correct.
Tax risk and legislative change	Is the tax risk strategy document a live document? This will require continual update particularly with regards to legislative change.
Production of QRT's	Is there adequate capability and resource within the tax department to produce quarterly regulatory Solvency II disclosures? Can an appropriate timetable be agreed with external providers of source data, e.g. Asset managers?

Institute and Faculty of Actuaries

11 November 2013

Page 28

What the tax department needs to do



Institute and Faculty of Actuaries

11 November 2013

Page 29

Institute and Faculty of Actuaries

Loan relationships and derivatives

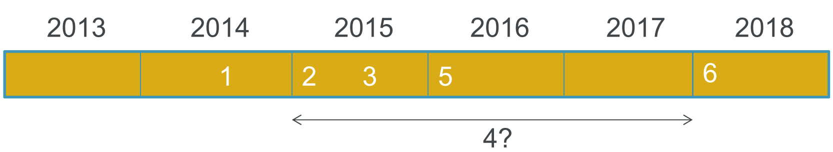
11 November 2013

Consultation

- HMRC issued a consultation document on 6 June 2013 for comment by 29 August
- Responses submitted by
  - ABI
  - ILAG
  - BBA
  - IMA
  - As well as many others
- Four major issues raised by ABI covered in detail
- Others include connected party debt and restructuring provisions

Institute and Faculty of Actuaries

Timetable - tax



1 Anti-avoidance measures

2 New UK GAAP

3 Other changes to loan relationship and derivative taxation

4 IFRS 9

5 Solvency II

6 IFRS phase II for insurance contracts

Institute and Faculty of Actuaries

Perpetual debt

- HMRC propose that generally perpetual debt will not be a loan relationship so that interest would be disallowed
- A special rule has been enacted for banks that Tier 1 and Tier 2 capital in debt form will be treated as loan relationships
- It is understood that HMRC are broadly receptive to aligning the treatment of capital instruments issued by UK insurers to those issued by banks
- Special rules are likely to be linked to the adoption of Solvency II
- Existing perpetual debt will be grandfathered but there may be a period when new issues will be inefficient for tax

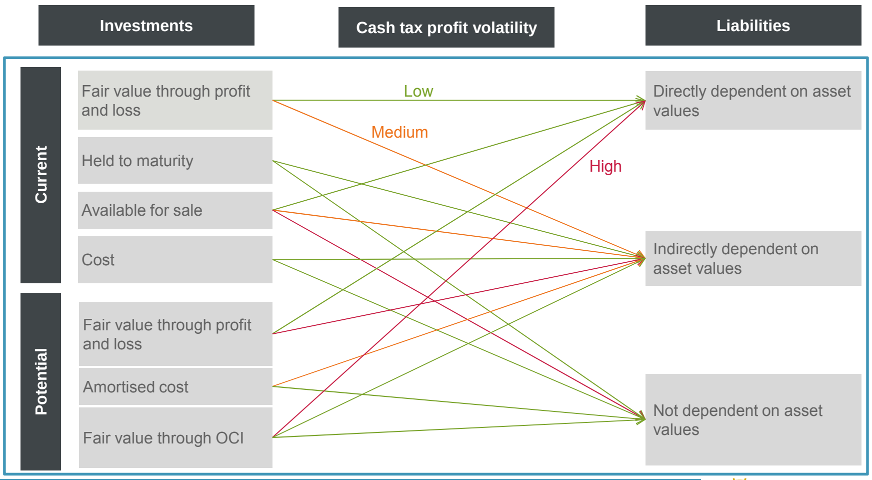
Institute and Faculty of Actuaries

Profit or comprehensive income

- HMRC are of the view that the true measure of trade profits is given by the profit and loss account
- OCI items are not part of trade profit unless included by statute
- Movements in value of investments in a financial trading company, such as an insurer, are currently included in trade profit by statute
- The consultation document on taxation of debt and derivatives proposes that movements in these items taken to OCI should be excluded from taxable profit
- Movements in insurance liabilities taken to OCI under IFRS phase II would not be included in taxable profits until they were recycled through profit and loss

Institute and Faculty of Actuaries

Gains and technical provision movements



The potential changes taken together could remove the current volatility for available for sale assets matched to items not dependent upon asset values and replace it with volatility for fair value through OCI assets matched to liabilities directly dependent upon asset values and fair value through profit and loss assets matched to liabilities indirectly dependent on them

Institute and Faculty of Actuaries

11 November 2013 Page 35

Profit or comprehensive income - conclusions

- Switches between current and deferred tax may impact the Solvency II balance sheet
- Potential changes affect different taxpayers in different ways:
  - For – companies currently with asset movements in OCI but liabilities not dependent on them
  - Against – companies with liabilities dependent on asset values but which may not be able to use fair value through profit and loss for assets
  - Against - companies with liabilities indirectly dependent on asset values where changes in discount will go to OCI but which use fair value through profit and loss for assets

The tax treatment of the IFRS phase II standard will need careful discussion with HMRC once it is finalised

Institute and Faculty of Actuaries

11 November 2013 Page 36

Corporate streaming

- HMRC proposed abolition of the corporate streaming rules where companies receive distributions from authorised investment funds not sourced from equities
- The current rules allow tax on fund income to be credited to its investors in particular those investing in property
- HMRC agree that this was not the original intention of the corporate streaming rules, but it is an effect of the current rules that has come to be relied upon
- HMRC now want to explore the impacts of the current proposals and to consider possible alternative proposals for reform of the rules, short of abolition

Direct investment may be needed for pension business

Institute and Faculty of Actuaries

11 November 2013 Page 37

Institute and Faculty of Actuaries

Questions

11 November 2013