The Actuarial Profession
making financial sense of the future

Life Conference and Exhibition 2011
The Actuarial Profession Tax Working Party
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Tax after Solvency II

21 November 2011

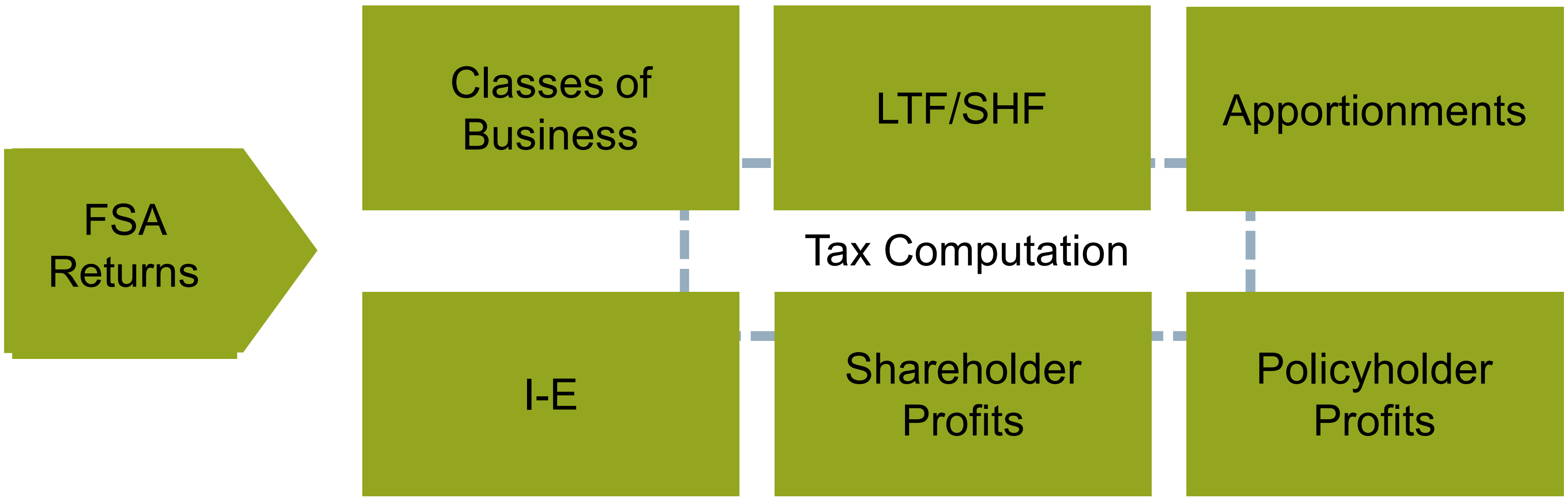
Tax after Solvency 2

Overview

- **Background (Matthew L)**
- **Solvency II (Matthew L)**
- Proposed Changes (Matthew T)
- Current Issues (Matthew T)
- What this might mean for Firms (Andrew)
- Practicalities (Andrew)
- Questions

Background

Key Elements of Solvency I Tax Base



Background

Solvency I Reporting Overview

- Classes of Business
  – BLAGAB (I-E)
  – GRB (Trading Profits)
  – PHI (Trading Profits)

FSA Returns

Classes of Business

- Companies in general taxed on Trading Profits
- Insurance Companies taxed on I-E, when writing BLAGAB
- Shareholder Profits

FSA Form 40 (Revenue Account)

Premiums	P
Income & Gains	I
Expenses	E
Claims	C
Profit	SP (= P + I – E - C)

Apportionments

Shareholder Profits

Background

Solvency I Reporting Overview

- Policyholder Profits

Claims	C
Premiums	P
Profit	PP (= C - P)

Policyholder Profits

- Consider both Policyholder and Shareholder Profits

Shareholder Profits	= P + I – E – C = I – E – (C – P)
Policyholder Profits	= C - P
SP + PP	= I - E

I-E

Background

Solvency I Reporting Overview

- Life Assurance Trade Profits (LATP)
  - A Profits based test providing a minimum value for tax
  - Excess of LATP over I-E (including dividend income) is deemed to be additional I
  - This excess is carried forward as unrelieved E (future relief)
- Formerly known as NCI Test
- Not relevant for Mutual Society
- Identifies PH and SH share …

Background

Solvency I Reporting Overview

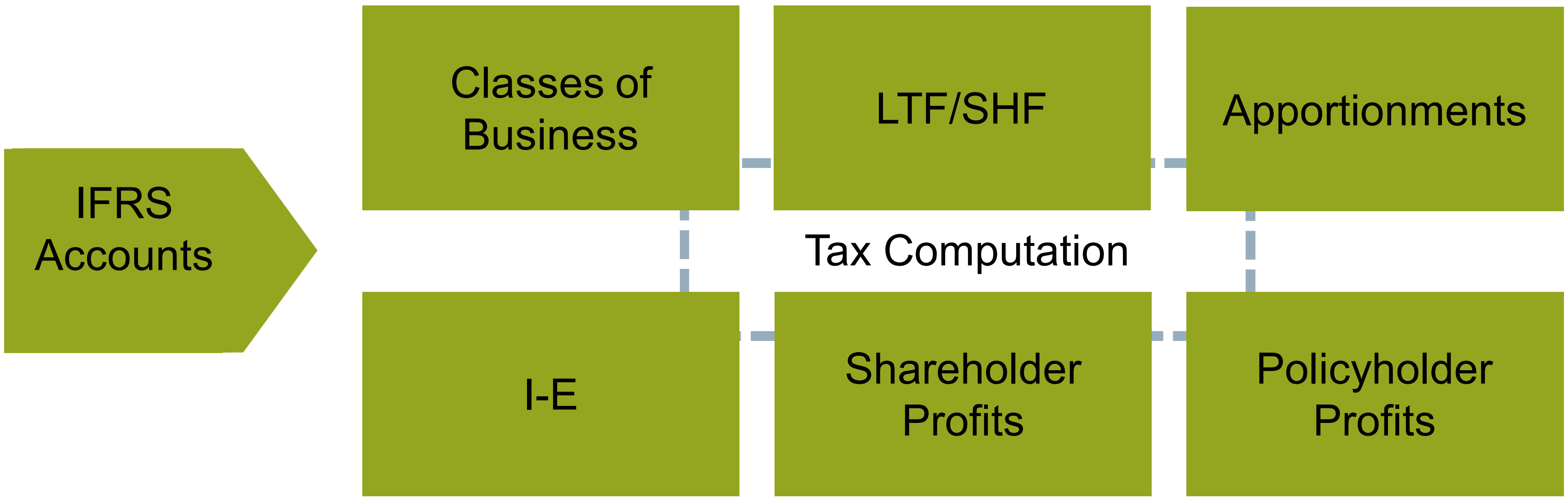
- Shareholder taxed at different Rate
  - Policyholder tax rate (20%)
  - Shareholder tax rate (glide path)

    28% in 2008 to 23% in 2013
- Shareholder Fund / Long Term Fund
  - Taxed as Investment Company

LTF/SHF

Background

Key Elements of IFRS Tax Base



Background

Tax consultation timeline

- TWP
  - Response to Consultation 2010
  - Response to Consultation 2011
  - Engaged with HMRC and FSA
  - Convention 2010 and 2011
  - Articles and updates published through 'The Actuary' and Webpage
  - Update on Draft Legislation in Early 2012

Solvency II

Level 2 Text - Draft Implementing Measures Solvency II

- Valuation of Assets and Liabilities
  - Deferred Tax Assets
  - Deferred Tax Liabilities
- Loss Absorbing Capacity of Deferred Tax
- Other Interactions
  - Calculation of Best Estimate Liabilities
  - Risk Margin
  - Own Funds
  - Group Issues

Solvency II

Valuation of Assets and Liabilities

- Deferred tax assets and Liabilities to be valued in accordance with Article 11 V7
  - References valuation basis to be in accordance with International Accounting Standards
  - The deferred tax value to be based on the difference in the value of the underlying assets and liabilities assumed in the valuation consistent with the Solvency II Directive and the value for tax purposes
  - Need to demonstrate ‘recoverability’ – Supervisory authority will require demonstration that future taxable profits are ‘probable’
  - ‘Probable’ to consider any legal or regulatory restrictions

Solvency II

Valuation of Assets and Liabilities

- Deferred Tax can therefore take the form of an asset or a liability
- Definition - Arises where there is a difference between economic value and the tax base. Deferred Tax arises where there is a difference between the Solvency II economic balance sheet valuation and the corresponding tax assessed value
- To put in context, DTA's are amounts of taxes recoverable in future periods:
  - Deductible temporary differences
  - Carry forward of unused tax losses
  - Carry forward of unused tax credits
- Examples of a Deferred Tax Asset (DTA)
  - Deferred Acquisition Expenses: Tax relief can be generated on acquisition expenses. This occurs on BLAGAB business when acquisition expenses are spread over future accounting periods. These are reflected as a DTA

Solvency II

Valuation of Assets and Liabilities

- Examples of a Deferred Tax Asset (DTA) continued
  - CGT Losses: This can take the form of unrealised losses on assets. A DTA is established where the current market value is less than that on purchase. Can also be carried forward realised capital losses.
  - XSE: A further example is the carry forward element of E, resulting from the LATP test within the I-E regime. The carried forward excess of E over I.
- Example of a Deferred Tax Liabilities (DTL)
  - Unrealised CGT Gain: A liability to pay tax can arise where assets have increased in price since purchase and the asset has not been realised and therefore the tax is not yet due. Such unrealised gains can give rise to a DTL

Solvency II

Loss-absorbing Capacity of Deferred Taxes

- Adjustment for the Loss-Absorbing Capacity of Deferred Taxes
  - The SCR comprises 3 elements - the Basic SCR, plus capital requirements in respect of Operational Risk, plus an adjustment in respect of the loss absorbing capacity of technical provisions and deferred tax (Article 103). The SCR therefore allows for the compensatory effect of movements in deferred tax within a stress scenario
  - The Deferred Tax loss absorbing capacity adjustment is calculated as equal to the change in value of deferred taxes from an instantaneous loss in the BSCR plus adjustment for loss absorbing capacity of technical provisions and capital requirement for Operational Risk
  - Within the BSCR scenario, there should be no change the value of the DTA's and DTL's. Need to consider recoverability and therefore the 'probable' future profit available
  - Allocation of benefit to risks is to be consistent with that of BSCR contribution and the capital requirement for Operational Risk
  - Where the calculation gives rise to a positive adjustment, the adjustment will be set to nil
- Reflection
  - Whilst not explicit it may be implied that the SCR permits reductions in **current tax** provisions within the base balance sheet or the creation of a DTA for taxes already paid. Trading losses and loan relationship deficits can be carried back to the prior year
  - The compensatory effect of **deferred tax** appears limited to the extent available under best estimate assumptions
  - DTA can arise from prudence in basis such as future profits on future premiums or emergence of liquidity premium in excess of that allowed, which are not recognised in Technical Provisions
  - The IM encompasses all scenarios, good and bad. Consideration should be given to reflecting tax on profits in good scenarios as it can impact the ranking of scenarios (BLAGAB interaction)
  - A PIM may be applied to the calculation of any one or more of the standard formula components (Article 112)

Solvency II

BEL

- Calculation of Best Estimate Liabilities
  - Tax payments to be reflected in the cash-flow projections
  - To include those charged to policyholders and those required to settle insurance or reinsurance obligations as well as the impact of expense relief.
  - This would include transaction based costs e.g. VAT within the BEL, but need to be aware of the possible double count where already reflected in the expense base
  - All other tax payments to be reflected in current or deferred tax within the balance sheet
  - Not assumed to include amounts relating to policyholders' income tax liability
  - Assumes a gross of tax discount rate

Solvency II
BEL

- Calculation of Best Estimate Liabilities - Reflection
  - BEL provides for policyholder liabilities as they fall due
  - Trading Profits can arise
    - Release of Risk (or other) margins
    - Differences between the assumption base and experience
    - Transfers to Shareholder (for With-Profits business)
  - Where experience follows assumptions, no Trading Profits will emerge and no associated Profits Tax providing a rationale
  - For BLAGAB (I-E), tax is suffered on future I less E. This needs to be reflected in the BEL or cash-flows will be overstated
  - For With-Profits business, future Shareholder profits are not reflected in the BEL so there is no requirement to reflect the associated Shareholder Tax within the calculation of the BEL. Where Shareholder Profits are reflected on the Balance Sheet, a DTL will be required

Solvency II

Risk Margin

- Risk Margin
  - The Risk Margin forms part of the Technical Provisions (TP)
  - Defined as an amount to ensure that TP's are equivalent to an amount that an undertaking would be expected to pay to take on the insurance liabilities of a firm
  - The calculation of Risk Margin is to assume no loss-absorbing capacity of deferred taxes in the calculation of the SCR for the reference undertaking over the lifetime of the business
- Risk Margin - Reflection
  - This simplifies the calculation of the Risk Margin, similar methodology to that of QIS 5
  - This may be a reasonable approximation given that tax risk will be a component of Operational Risk

Solvency II
Own Funds

- Own Funds (excess of assets over liabilities)
  - Net Deferred Tax Asset classified as Tier 3 Basic Own Funds if criteria met (Article 63 COF6)
  - Eligible Tier 3 restricted to 15% of total eligible Own Funds (Article 72 EOF1)
  - Eligibility restrictions also apply to MCR
  - May be an issue for Group Structures …

Solvency II

Group Issues

- Availability at Group level of Eligible Own Funds of related undertakings
  - There is a presumption that the value of a net DTA cannot be made available for the Group. ‘Net’ refers to the fact that the DTA may be reduced by the available DTL
  - A DTA can be available where rebuttal can be demonstrated ‘**to the satisfaction of the supervisory authorities**’ that the presumption is inappropriate
- Eligible Own Funds - Reflections
  - The IM encompasses all scenarios, good and bad. Consideration should be given to reflecting tax on profits in good scenarios
  - Important to consider the DTA of the ‘biting scenario’ of the Group within the IM as it can impact the ranking of scenarios
  - Consideration should also be given to an assessment of whether when a loss occurs, deferred tax can increase the SCR. This can occur when the best estimate DTA may cease to be recognised
  - Question of fungibility and transferability of the DTA between different territories

Tax after Solvency II

- Background (Matthew L)
- Solvency II (Matthew L)
- **Proposed Changes (Matthew T)**
- **Current Issues (Matthew T)**
- What this might mean for Firms (Andrew)
- Practicalities (Andrew)
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UK tax policy timetable

	1 January	31 March	30 June	30 September 31 December
2010				Agreement of principles
2011	Submission to Ministers 14 February	Principles Announced at Budget 2011	Further submissions to Ministers for detailed legislative drafting	Draft primary legislation published 6 December
2012	Draft secondary legislation	Finance Bill 2012		

Proposed changes to life assurance taxation

1) New basis of taxation of long-term business from 1 January 2013
2) I minus E and trade profit computations
3) Allocation
   - Income and gains
   - Pre-tax profits
   - Fiscal deductions
4) Life assurance fixed capital
5) Deductions
   - Liabilities
   - Policyholder profits
   - Policyholder tax
6) Exempt dividends
7) Mutual trading
8) Transfers of business

(1) New basis of taxation of long-term business from 1 January 2013

- Taxable profit based upon profit before tax from the statutory accounts plus taxable items in other comprehensive income and taken to reserves, i.e. taxable profit will be accounting profit wherever it appears in the financial statements
- Tax relief for provisions for liabilities to policyholders including bonuses declared, provisions for bonuses, other provisions for liabilities to policyholders (both insurance and investment accounted contracts), and risk and residual margins as required under IFRS Phase II
- Possible carry-back of excess expenses
- Legislation being drafted

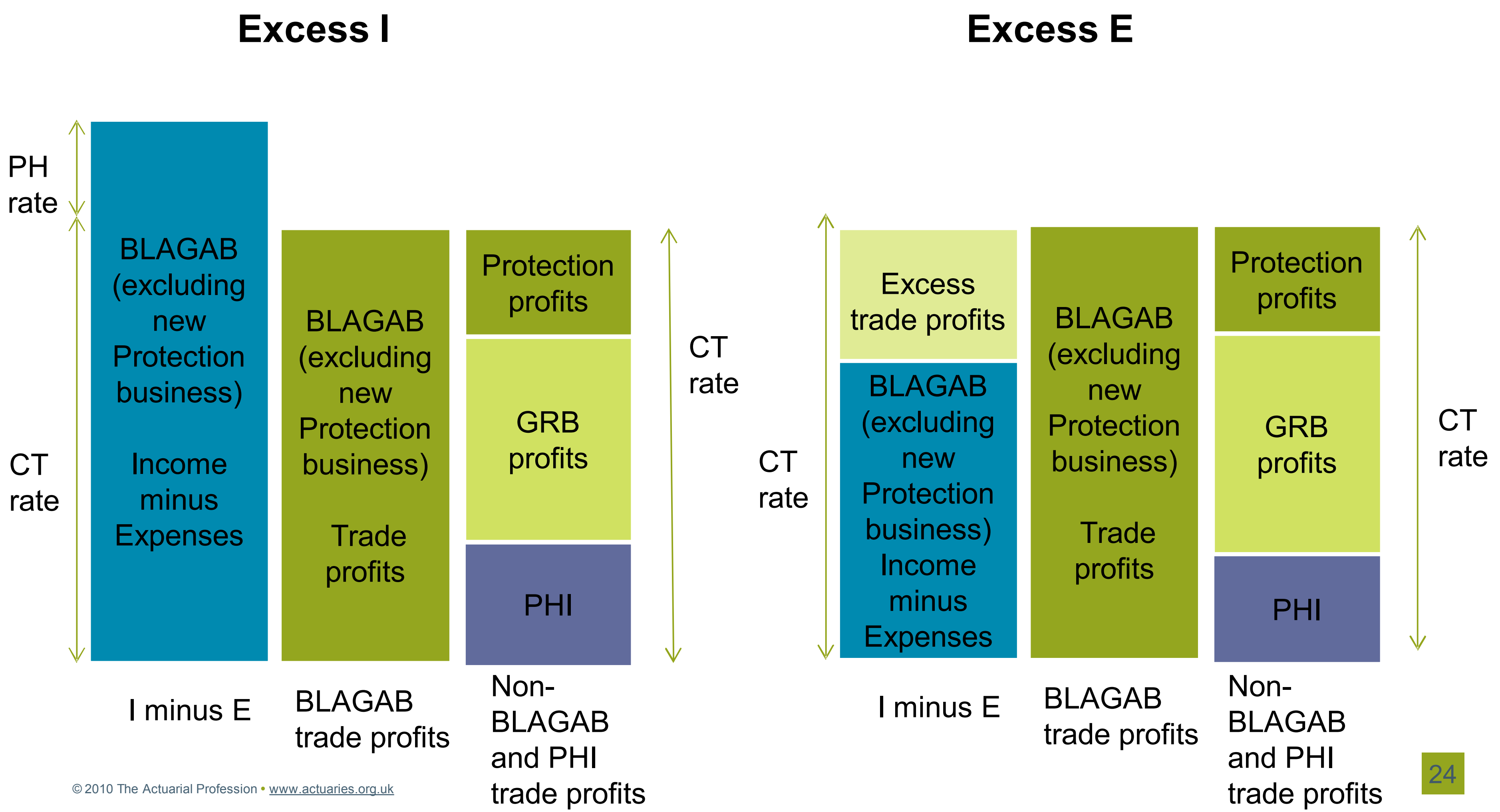
Tax to be based on financial statements

(2) I minus E and trade profit computations

- Two categories of long term insurance business, basic life assurance and general annuity business (BLAGAB) and "non-BLAGAB and PHI business"
- Protection business written on or after 1 January 2013 will be "non-BLAGAB and PHI business"
- Once enacted, this will mean:
  - BLAGAB being dealt with as now on an I minus E basis subject to the minimum profits test
  - "non-BLAGAB and PHI business" being taxed on the basis of trading profits that could be relievable against BLAGAB trading profits or group relieved.
  - Current GRB losses converting to "non-BLAGAB and PHI business" trading losses on transition, but current life assurance trade losses only converting to BLAGAB trade losses if in excess of current GRB losses

Future "non-BLAGAB and PHI business" losses obtain immediate relief and so avoids this business having to be written in subsidiaries

I minus E and trade profits computations - illustrations

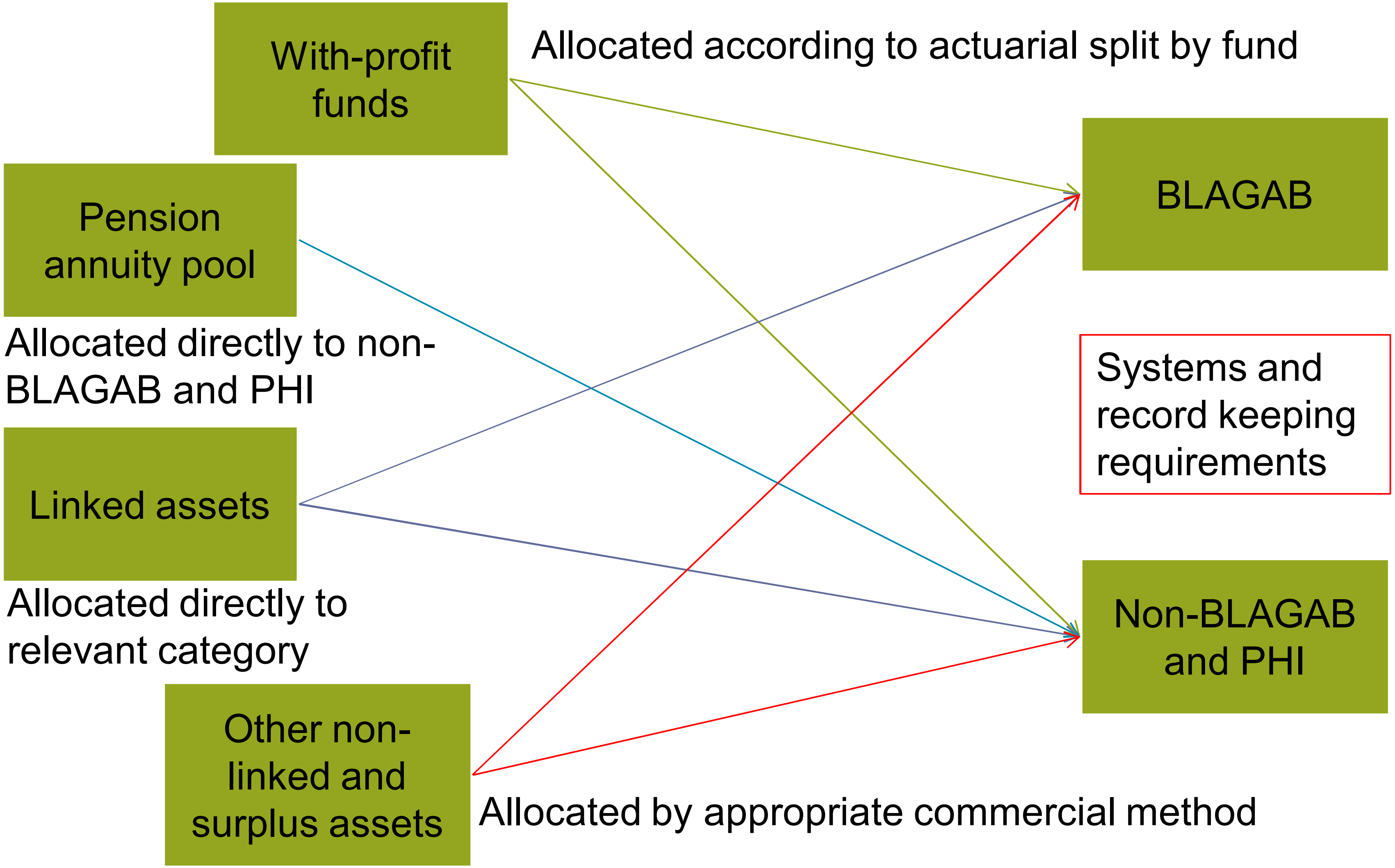


(3) Allocation

- Commercially based allocations to be agreed with CRM rather than apportionments
- Regulations to limit range of possible allocations
- A commercial allocation of all items of income and outgo, accepting that some items may need to be sub-allocated on a formulaic basis
- Matching of tax treatment to underlying business will be particularly useful for annuity business
- For with-profit funds, pre-tax profit (after relief for UDS) potentially allocated pro rata to bonuses
- Consistent approach for I minus E and trade profits
- Direct attribution of fiscal adjustments to result in allocation of 100% of taxable profits

Tax payable likely to be consistent with allowance made for in modelling

Allocation – income example



Allocation - chargeable gains example

Non-BLAGAB linked /matched

Direct allocation

BLAGAB linked /matched

Direct allocation

With profit fund 1

With profit fund 2

In proportion to asset shares

Separate pool records required with deemed disposals for inter-pool transfers

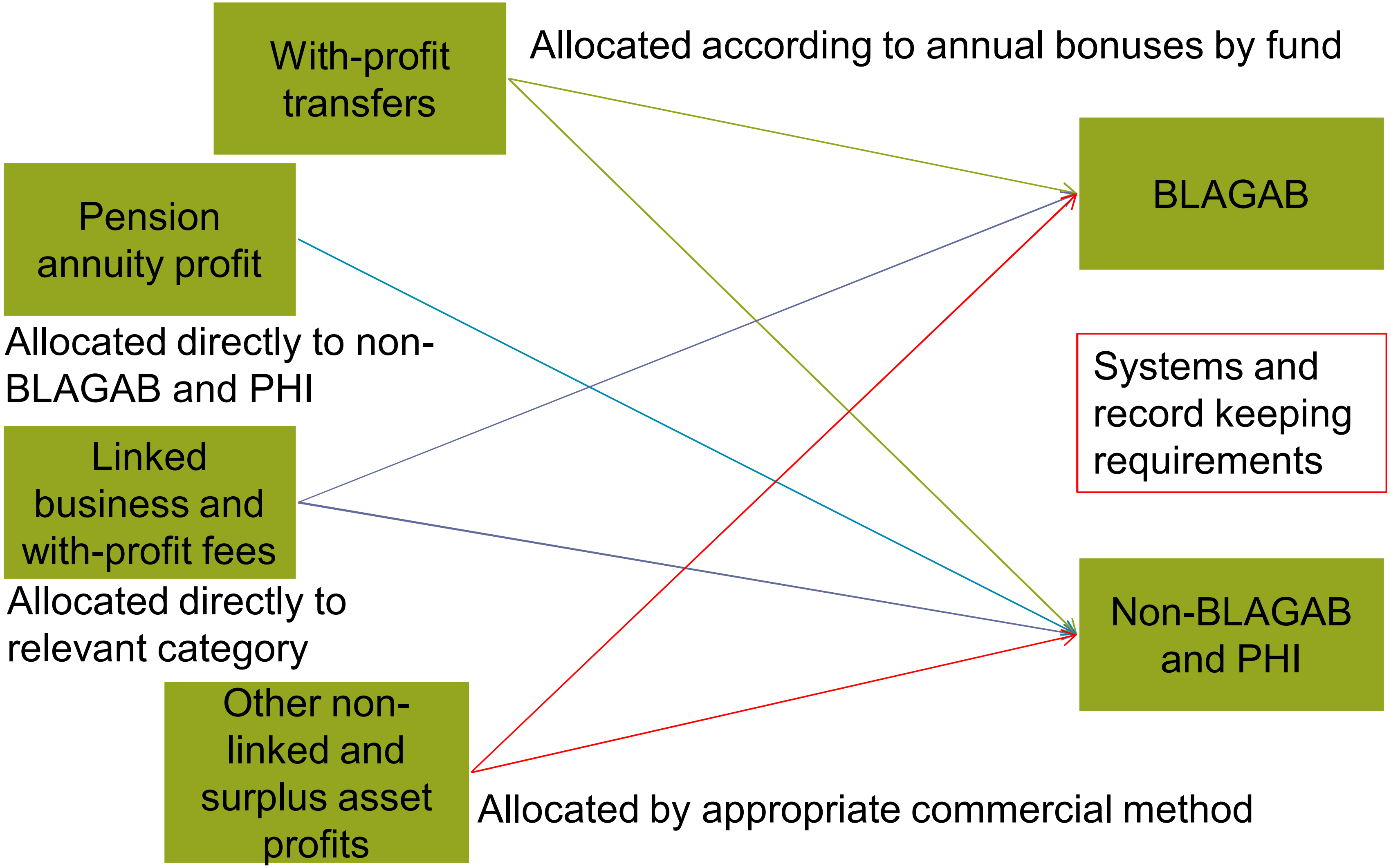
Balance of trade assets

Non-profit fund liabilities or Appropriate commercial method

Life assurance fixed capital

Not allocated – separate taxation

Allocation – profits example



(4) Life assurance 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 of held as fixed assets to facilitate it.
- Consideration is being given to the possibility that a life company could hold a pool of investments separate from the trade assets (an ancillary investment business) but which would not normally qualify as “fixed assets”. Such a pool could be included with life assurance fixed capital.
- On transition, it is proposed that current shareholder fund assets and long-term fund insurance dependents be regarded as part of life assurance fixed capital.

Potential loss of realisations basis for shareholder fund equities

(5) Deductions in arriving at taxable profits

- Relief for policyholder cash tax in the calculation of trading profits.
- Relief for policyholder deferred tax referred to Ministers.
- For with-profit funds:
  - relief for bonuses declared
  - relief for the provision for terminal bonuses
  - relief as a provision for liabilities to policyholders of the unallocated divisible surplus (UDS) or fund for future appropriations.

HMRC will not give a deduction for regulatory capital

(6) Exempt dividends

- The proposals here are to minimise change.
- For the minimum profits test, the comparison will continue to be between I minus E profit plus BLAGAB exempt dividends, and the BLAGAB trading profit including exempt dividends.
- Where a company is excess E but has trade profits less than BLAGAB exempt dividends, tax on trade profits would continue to be nil.
- The shareholders' share of exempt dividends would be subtracted from trade profits in determining the amount of profit taxable at the CT rate.
- The way in which the shareholders' share of exempt dividends will be determined is still under active discussion.

Reducing taxable shareholder profits by a proportion of dividend income is expected to continue

(7) Mutual trading

- Mutual trading either to result in a profit which is then not taxable or in no profit.
- If there is no profit, fiscal deductions are not important.
- Will “non-BLAGAB and PHI business” be mutual business as PHI currently is frequently not?

Need to avoid collateral damage

(8) Transfers of business

- Development of an appropriate regime consistent with the general tax regime for life insurance business.
- Tax likely to follow the accounts for third party transfers but with "stand in the shoes" treatment for connected party transfers.
- Intangible asset regime extended to life assurance business.
- Anti-avoidance may extend to I minus E as well as trade profits.

Part VII transfers to optimise use of E may be ineffective

Transitional adjustments

- The total transitional adjustment will be calculated at 31 December 2012
- A transitional measure is to be introduced to provide for:
  - Identifiable components whose initial quantum can be established from the company's books and records and whose expected reversal pattern can be estimated *ab initio* using established actuarial or accounting techniques such as deferred acquisition costs and the value of in force business – spread in accordance with that expected reversal pattern
  - The establishment of an opening position for any policyholder deferred tax adjustment
  - Residual component – spread over a period of 10 years from 2013
- Specific transitional measures will also be required, for example to deal with the switch to an allocation basis for assets subject to tax on chargeable gains, contingent loans and FAFTS

Summary impact of transitional adjustments

	Transitional adjustment	Impact on Tier 1	Tier 1 affected upfront?	Comment
1	**Upfront tax deduction**			
	Impacts CT only	Benefit	Yes	
	Creates/increases DTA	Benefit	No - Tier 3	Tier 1 affected as/when realised
	Reduces DTL	Benefit	Yes	
2	**Upfront taxable profit**			
	Impacts CT only	Cost	Yes	
	Reduces DTA	Cost	No - Tier 3	Tier 1 affected as/when realised
3	**Spread tax deduction**			
	Creates/increases DTA	Benefit	No - Tier 3	Tier 1 affected as/when realised
	Reduces DTL	Benefit	Yes	
4	**Spread taxable profit**			
	Creates/increases DTL	Cost	Yes	
	Reduces DTA	Cost	No - Tier 3	Tier 1 affected as/when realised

When to recognise changes

- IAS 12 for the IFRS accounts requires substantive enactment, generally accepted as 3rd Reading of the Finance Bill which can be expected in July 2012
- IAS 10 requires disclosure of changes enacted or announced after the reporting period that have a significant effect on tax balances
- MCEV principles require "*best estimate assumptions, applying current legislation and practice together with known future changes*". *"Best estimate assumption"* is defined as being *"equal to the mean estimate (probability weighted average) of outcomes of that risk variable"*

Test for MCEV may be weaker than for financial statements and changes may need to be taken into account earlier

What is a known future change?

- Statements by officials - looks too weak
- Statements by Ministers – stronger but still uncertain
- Budget Statements to the House of Commons – would need a “U turn” not to happen
- Draft legislation – subject to consultation so detail uncertain
- Published Finance Bill – subject to amendment but areas for amendment themselves likely to be known
- 3rd Reading of Finance Bill – substantive enactment

Prospective reductions in corporation tax below 25% fall into the third of these. The 25% rate is already enacted

How many transitions?

- 1 January 2013 – Solvency II for regulators
- 1 January 2014 – Solvency II for companies
- 1 January 2014 – UK GAAP reporting switches to FRSME including life assurance
- 1 January 2015 – effective date for IFRS phase II?

1 January 2013	1 July 2014	1 January 2015
Solvency II for regulators	Solvency II for companies End of UK GAAP	IFRS phase II

As the effective date for IFRS Phase II looks later than that for Solvency II, the tax basis for life assurance in the UK may change twice – first from Solvency I to IFRS 4, then from IFRS 4 to IFRS Phase II.

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Impact on Firms
Taxable profits based on financial statements

- Managing IFRS profits becomes more important
- Taxable profits could be more volatile, especially for with profit companies with supporting non profit funds on which profits are currently smoothed via Form 14 investment reserves

Impact on Firms
Protection business written after 1 Jan 2013

- Most protection business creates more expenses than investment income
- "Excess I" companies gain by offsetting the excess expenses against income elsewhere
- Taxing new protection business on a profits basis will level the playing field but potentially result in higher prices to consumers

Impact on Firms
Merging PHI and Gross Roll-up Business (GRB)

- Could enable PHI losses to be offset against GRB profits and vice versa
- Beneficial for solo firms as may enable additional access to or acceleration of relief on losses
- Could be bad for groups – Losses in other companies can be group relieved against PHI profits but not against GRB profits
- May also be transitional “streaming” rules so existing losses can only be offset against profits from the same source

Impact on Firms
Factual allocation of investment returns

- Current apportionment rules can give strange results
  - Unfairly penal in some cases
  - Scope for arranging business structure to gain value
- New rules should reflect reality
  - Less incentive for complex structures
  - And easier to model!

Impact on Firms
Shareholder funds vs "Fixed capital"

- Concept of shareholder funds disappears under Solvency II – there are just Ring Fenced Funds and everything else
- Actuaries might want to manage as a single asset pool
- **But** could follow concept of ancillary investment business
- Combination of ancillary investment business and life assurance fixed capital is work in progress.

Impact on Firms
Policyholder Tax

- Shareholder profits should exclude returns to policyholders
- Policyholder tax must be allowed for – otherwise income of 100 and credit to life liabilities of 80 would give rise to a shareholder profit of 20
- The intention is to maintain this credit but the credit may be based on tax paid, i.e. excluding deferred tax
- So capital gain of 100 and credit to liabilities of 80 could cause shareholder tax to be paid (because the 20 of deferred tax liabilities is ignored)
- We have responded to HMRC highlighting risk that policyholders may bear this loss

Modelling practicalities
Change in tax regime

- Most actuarial models include projections of peak 1 reserves which drive the current tax calculations
- With tax based on IFRS, the consistency breaks down
  - Deferred tax impacts due to differences between opening peak 1 and IFRS bases
  - Some form of adjustment to adjust from projected peak 1 earnings to projected IFRS profits
- New apportionment basis should be easier to model
- New regime comes before Solvency II – unlikely to want to make large changes to Solvency I models just for one year
- Then just as Solvency II is embedded, IFRS phase II will introduce more change

Modelling practicalities
Solvency II

- Generally higher bar for quality of calculation approach
- Standard Formula SCR includes specific item for loss absorbency of deferred tax, whereas tax effects would typically be allowed for in each stress under ICA
- Requirement to perform Group SCR/ORSA heightens need to consider whether group relief can justifiably be assumed

Questions or comments?

Expressions of individual views by members of The Actuarial Profession and its staff are encouraged.

The views expressed in this presentation are those of the presenter.