The Actuarial Profession
making financial sense of the future

Highlights of the 2010 Life Conference
Actuarial Profession's Tax Working Party: Trevor Fannin and Matthew Taylor

Taxation in a Solvency II world

17 February 2011

Issues

- Loss of FSA Returns (current basis used for tax returns)
- New profit measures: Solvency II vs IFRS
- Potential for change in I-E

Agenda

- Refresher to life office taxation (Trevor)
- Graphical change in reporting (Trevor)
- Consultation process (Matthew)
- Solvency II – UK tax policy issues (Matthew)
- Transitional arrangements (Matthew)
- Other UK tax policy issues (Matthew)
- QIS5 issues (Trevor)

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Taxation in a Solvency II world

Refresher to life office taxation

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Background

- All companies taxed on trading profits
- Insurance companies taxed on I-E basis where they write BLAGAB business
- Tax on both policyholders profits and shareholders profits

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Overall I-E for a proprietary is…..

"BLAGAB I-E" + "GRB profits"

"BLAGAB I-E"

- Income
  - Unfranked investment income (exempt dividends ignored)
  - Indexed realised gains (net of losses)
  - Deemed disposals on all collective investment schemes (spread over 7 years)
  - Capital increases in loan relationships
- Expenses
  - Renewal expenses
  - Acquisition expenses including renewal commission (spread over 7 years)
  - Unrelieved expenses brought forward ("XSE")
  - Capital decreases in loan relationships
  - Income content of general annuities

GRB profits

- GRB profits are effectively shareholder profits, as policyholder returns do not get taxed.

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Does BLAGAB I-E makes sense?

I-E tax is a tax on **profits**
It taxes profits made by shareholders **and** profit made by policyholders
Proof
Revenue Account

Premiums	P	
Income + gains	I	
Expenses	E	
Claims	C	(including increase in reserves)
Pre tax profit	SP	(shareholders profit)

SP = P + I – E – C = I-E – (C-P)

Policyholders profit (PP) is the excess of claims received over premiums paid and hence PP = C-P
thus
SP = I-E – (PP)
I-E = SP + PP

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Excess Trade Profit Test

- HMRC want to tax SP at 28% and PP at 20% hence they split the I-E into two components
- Shareholder's share of I-E is Trade (formerly NCI) profits
- Trade Profit is also used as the minimum value for the I-E. When the minimum applies, the excess of Trade Profit over I-E (incl exempt dividends) is deemed to be additional income,
- …. but that excess and any E unrelieved in I-E is carried forward for possible relief in future years

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Deferred tax liabilities – how they could be created?

- A DTL will arise when the company has recognised more surplus on the balance sheet than it has paid tax upon. In this case the company expects to pay tax in the future and the DTL represents a liability for this tax.
- A DTL can arise due to the fact that assets are valued at market value on the balance sheet, while tax may not be paid on an increase in the value of assets (compared to the purchase price) until the asset is sold i.e. until the gain is realised. Ignoring the future tax that would be paid on these unrealised gains would overstate the company's surplus shown under Solvency II. Therefore, a DTL needs to be set up in the balance sheet
- A firm purchases an asset for 100 in year 0. In year 1 the market value of the asset falls to 80, but then rises to 140 in year 2. In year 3 the asset is sold and a gain of 40 is realised. Tax is assumed to be paid on the sale of the asset, based on the difference between the sale price and the purchase price of the asset. We assume a tax rate of 50%. For simplicity we ignore discounting.

	Year 0	Year 1	Year 2	Year 3
Balance sheet				
Assets MV	100	80	140	-
DTA		10		
DTL			20	
Tax Basis				
Assets BV	100	100	100	-
Liabilities	-	-	-	-

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Deferred tax assets – how they could be created?

- A DTA will arise when the company expects to pay less tax in future because of a difference between the economic balance sheet and the tax base. Some examples could be
- **Unrealised losses on an asset:** A DTA could be created if the market value of assets shown on the Solvency II balance sheet is below the purchase price of these assets. .
- **Acquisition expenses:** Tax relief on BLAGAB acquisition expenses is spread over seven years so part of the future cash flows of a life company may include tax relief on historic cash flows, these can be captured as a DTA. Similarly the statements may include a DAC asset to spread the impact of acquisition expenses in which case it would be necessary to hold a corresponding DTL in respect of any tax relief already received on the deferred costs.
- **Past losses which offset future profits:** If a company can offset a past loss against future profits for tax purposes then a DTA could arise. A loss would reduce the surplus shown on the Solvency II balance sheet but reduced tax would be realised in the future, so a DTA would be set up to reflect the value of this benefit.

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The crux of the matter

- Timing in recognition of surplus
- Asymmetry of tax

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Taxation in a Solvency II world

Graphical change in reporting

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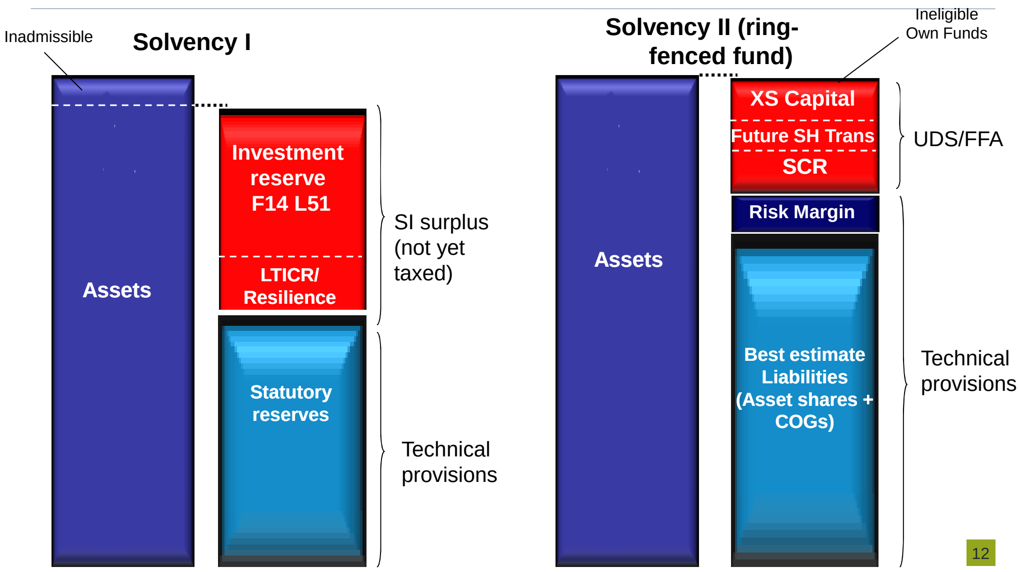
Ring-fenced funds (SI to SII)



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Observations on ring-fenced funds (SI to SII)

- The investment reserve (the amount disclosed on line 51 of Form 14 of the FSA returns) is the excess of the market value of the assets of the with-profits fund over the deterministic prudent value of the minimum policy benefits. These are profits that are allocated between policyholders and shareholders according to each company's articles but are normally allocated 90% to policyholders and 10% to shareholders. Although the board has discretion over the extent of profit to recognise in a year, in most cases the amount recognised is equal to the amount required to pay for the cost of bonuses for the year plus the amount that is consequently due to shareholders.
- The shareholders transfers are to be taxed (10% of cost of bonus) at corporation tax rate, however this is not until it passes through Form 40 (in the meantime it sits in the investment reserve). Whilst the FSA returns recognise assets at market value, Form 40 (the revenue account) uses adjusted book values where increases in asset values are recognised at the firm's discretion.
- The FFA/UDS for Realistic Balance Sheet firms differs from the amount disclosed on line 51 of Form 14 of the FSA returns. The FFA is the excess of the market value of the assets of the with profits fund over the realistic liabilities of the policies (simplistically the asset shares plus the value of policy options and maturity guarantees). The key difference is that the FFA is already net of the cost of expected future policy bonuses where as the investment reserve includes the value of all future expected bonus allocations plus any additional value but is calculated on a prudent basis.
- QIS5 indicates that provisions are only held for future policyholder liabilities and the value of future shareholder transfers not held as a provision but shown as surplus (this is different to RBS calculations). As a result a DTL should to be shown in respect of these transfers.
- Also no provision for the estate if it's not expected to be distributed. It is recognised that surplus in ring fenced funds cannot be used to meet losses in other funds and so only capital needed to cover SCR in the fund and the value of shareholder transfers is eligible towards meeting company's overall SCR with any excess ineligible.

Investment reserve replaced with a provision for future bonuses and a UDS/FFA which is shown as surplus in the fund.
DTL to be set up in respect of future shareholder transfers

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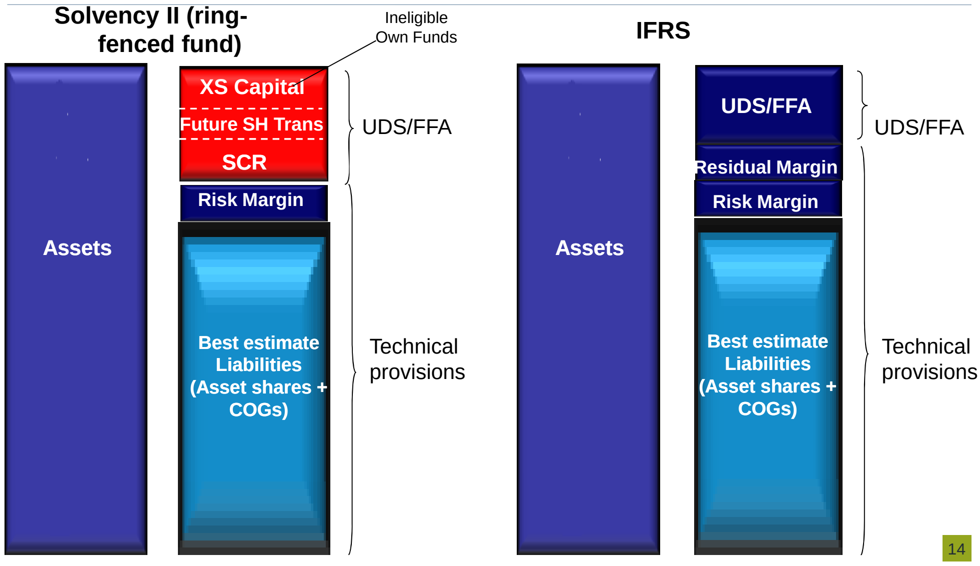
Ring-fenced funds (SII vs IFRS)



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Observations on ring-fenced funds (SII vs IFRS)

- Under proposed IFRS, a residual margin will be included on day 1 for new business to defer the emergence of surplus. This increase will be part of the technical provisions. Best estimate and risk margin may differ slightly due to discount rates used or CoC rates, however assumed same for now.
- We have assumed that assets for shareholder transfers and the estate will be treated as UDS/FFA under IFRS and shown as a provision, in which case no tax is payable until transfers are made in each future year. If this is the case then one would expect minimal impact to now for taxation of WP funds.
- However it may be that UDS/FFA will disappear and any tax in respect of shareholder transfers payable now. However this would seem very penal, having to pay tax today on distributions not payable until the future.

If, under IFRS, a provision is set up for the UDS/FFA (covering estate and shareholder transfers) then expect minimal impact as no tax payable until shareholder transfers are made in the future. Treatment of the UDS/FFA is yet to be confirmed under IFRS.

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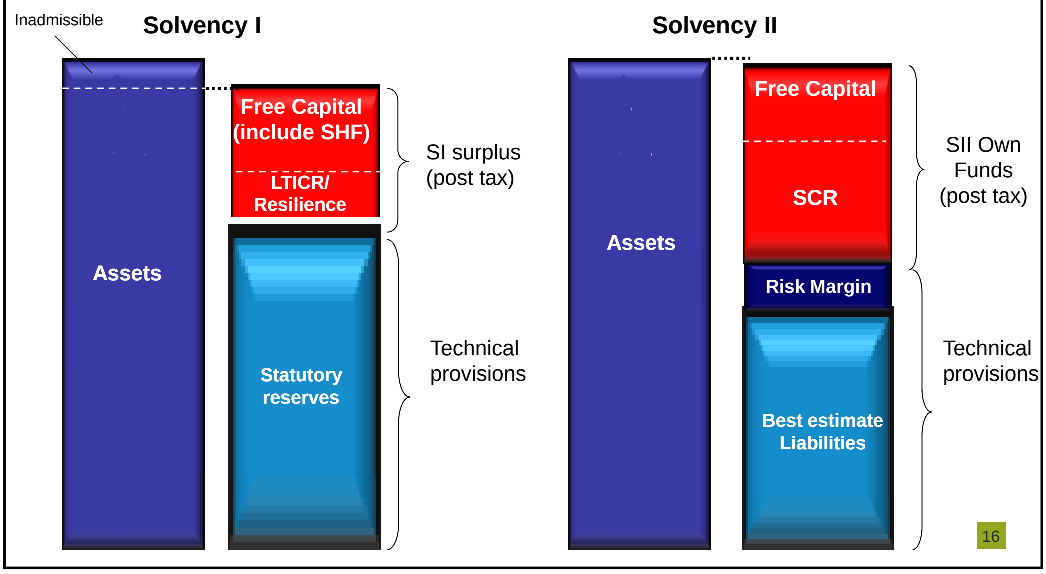
Balance of company (SI to SII)



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Observations on balance of company (SI to SII)

- Most companies now recognise all gains and losses as they arise for their non profit business in Form 40 (the revenue account) and so any surplus shown is post corporation tax. Exceptions relate to companies that have with-profits funds and a few other exceptions reflecting historical practices or Court scheme requirements.
- Current Solvency I calculations defer recognition of profit by requiring companies to hold prudent mathematical reserves for policy liabilities. Since taxable profit is based on the Solvency I result, tax is correspondingly deferred until profit is recognised on a Solvency I basis. Additionally companies are required to hold at least a minimum level of additional capital in excess of the sum of mathematical reserves and other liabilities but these do not obtain tax relief and so such capital is currently accumulated out of post tax sources.
- Under SII statutory reserves are replaced with best estimate plus risk margin. Generally for unit-linked business this will mean a release of technical provisions and hence surplus. However for some business (e.g. annuity business) this may mean an increase in technical provisions and hence a loss. That surplus/loss between SI and SII will need a DTL/DTA held in respect of it.

A DTL or DTA is held under SII (for QIS5) in respect of change in level of surplus between SI and SII

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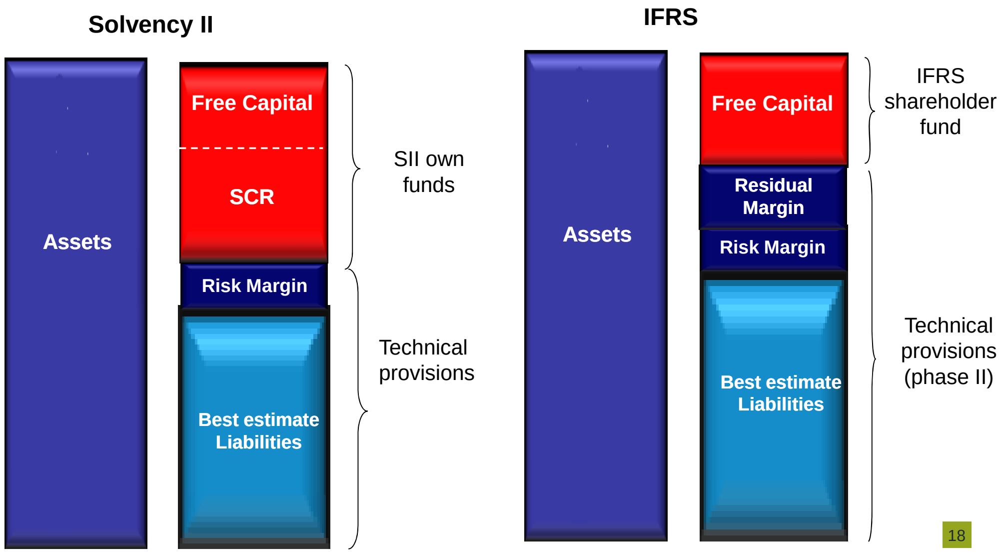
Balance of company (SII vs IFRS)



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Observations on balance of company (SII vs IFRS)

- Contracts within the definition of insurance contracts are dealt with currently under IFRS 4, but this standard is to be replaced with the IFRS Phase II standard for insurance contracts.
- Other contracts which are regulated as insurance business are treated for accounting as investment contracts under IAS 39.
- To the extent that unit-linked policies are dealt with as investment contracts, the reduction in reserves under SII will not be reflected in IFRS profit as the surrender floor is applied under IFRS, and so the acceleration of profit will not arise.
- It is not clear how the risk margin will compare and there will be an additional residual margin and then a level spreading of expected profit throughout the term of the contract that will defer the emergence of profit.

A DTL or DTA will need to be held under SII to reflect the difference in surplus recognition between SII and IFRS (the difference between SI and IFRS will be crystallised as immediate credit or liability on transition). It is expected that there will be a deferred emergence of IFRS surplus relative to SII and so a DTL held.

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Taxation in a Solvency II world

Consultation process

Consultation to date

- Informal discussion began in July 2009
- Formal consultation paper (10 March 2010)
- Consultation ended 3 June 2010
- HMRC working groups established in June 2010 to cover specific areas (Industry representatives and “Big 4” firms)
  - WG1 – shareholder profits and transition
  - WG2 – Interaction with I – E, minimum profits test and apportionment
  - WG3 – Changes to I – E, treatment of protection business
  - Mutuals and friendly societies
  - Transfers of business

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	Submission to Ministers for detailed legislative drafting		Draft Legislation published with Autumn Statement
2012			Finance Bill 2012	Regulations to accommodate any final changes to Solvency II	

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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
- 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

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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 27% fall into the third of these. The 27% rate is enacted

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Taxation in a Solvency II world

Solvency II – UK tax policy issues

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Solvency II – UK tax policy issues

1) Expected new basis of taxation of long-term business
2) Taxation of structural assets, shareholder fund assets or assets on capital account
3) Number of trade profit computations
4) Exempt dividends
5) Deductions
   - Liabilities
   - Unavailable profits
   - Policyholder tax
6) Mutual trading
7) Apportionment
   - Income and gains
   - Fiscal deductions
8) Transfers of business

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(1) Expected new basis of taxation of long-term business

- Taxable profit based upon profit before tax from the statutory accounts plus taxable items in other comprehensive income and taken to reserves.
- In summary therefore, taxable profit would be accounting profit wherever it appears in the financial statements
- Tax relief would be given 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
- Officials have indicated likely to be agreed by Ministers

Tax to be based on financial statements

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(2) Taxation of structural assets, shareholder fund assets or assets on capital account

- If the current segregation of the shareholder fund and the long-term fund is maintained for regulatory purposes, the current tax treatment is expected to continue. This means that shareholder fund equities would still be taxed on realisation not annual mark to market and that dividends from them would be exempt. Insurance dependents would still continue to be treated as if they were in the shareholders fund even if they were in a non-profit fund of the long-term fund.
- If the current segregation of the shareholder fund and the long-term fund is not maintained within the regulatory regime, return on assets and associated outgo would need to be dealt with as being on trading or on capital account from first principles, ie by reference to whether the assets were part of the trade of held as fixed assets to facilitate it.
- On transition, it is proposed that current shareholder fund assets and long-term fund insurance dependents be regarded as fixed assets on capital account.
- FSA still considering future of segregation. First principles approach appears to be preference of officials but no indication of Ministerial view until 23 March.

Loss of realisations basis for shareholder fund equities

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(3) Number of computations

- Current practice is long term insurance business includes BLAGAB and GRB. There is an issue that any GRB losses reduce life assurance trade profits but not I-E. As a result, immediate relief of 8% but deferral of 20% relief until GRB profits arise in the future.
- Proposal is to have two categories of long term insurance business, basic life assurance and general annuity business (BLAGAB) and gross roll-up business (GRB); GRB and current PHI would be combined. This appears to be preference of officials but has not yet been put to Ministers
- If enacted, this would mean:
  - GRB being taxed on the basis of trading profits that could be relievable against BLAGAB trading profits or group relieved.
  - Current GRB losses converting to GRB trading losses on transition
  - BLAGAB being dealt with as now on an I-E basis subject to the minimum profits test

Future GRB losses obtain immediate relief and so avoids GRB having to be written in subsidiaries

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(4) Exempt dividends

- The proposals here are to minimise change. They are still subject to detailed discussion with officials
- For the minimum profits test, the comparison would continue to be between I-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

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

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(5) Deductions in arriving at taxable profits

- Relief for policyholder tax in the calculation of trading profits. Officials have indicated likely to be agreed by Ministers
- Deductions are under discussion with officials for:
  - Elective deferral of amounts whose transfer to shareholders is restricted by a Court Scheme or other regulatory requirements, with taxation as those amounts are released from the restrictions. This would apply both to restricted amounts on transition and to subsequent increases in restricted amounts eg where these are added to a with-profit support fund
  - For with-profit funds, relief as a provision for liabilities to policyholders of the unallocated divisible surplus (UDS) or fund for future appropriations and, should that accounting treatment not continue under IFRS Phase II, tax relief for an amount equal to what would be the UDS under IFRS 4
  - For non-profit funds, relief for any excess of technical provisions required under Solvency II over the IFRS balance sheet provisions for liabilities to policy holders

HMRC will not give a deduction for regulatory capital

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(6) Mutual trading

- Mutual trading either to result in a profit which is then not taxable or in no profit. Officials have indicated likely to be agreed by Ministers
- Deduction for UDS being discussed with officials, if reflected in retained earnings not liabilities
- Will non-BLAGAB be mutual business as PHI currently is frequently not?

Need to avoid collateral damage

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(7) Apportionment

- The proposals here are still subject to detailed discussion with officials
- Commercially based allocations rather than apportionments, ie actuary determines allocation of investment return
- For with-profit funds, total taxable profit (after relief for UDS) allocated pro rata to bonuses
- For non-profit funds a commercial allocation so far as possible of all items of income and outgo, accepting that some items, such as investment return on assets held to back the business as a whole, will need to be allocated on a formulaic basis
- Matching of tax treatment to underlying business will be particularly useful for annuity business
- Direct attribution of fiscal adjustments to result in allocation of 100% of taxable profits

Tax payable to be consistent with allowance made for in modelling

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(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.

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Taxation in a Solvency II world

Transitional arrangements

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Transitional adjustments

- The total transitional adjustment, and any specifically identifiable components, may give rise to either profits or losses
- An elective transitional measure is being discussed with officials to provide for:
  - Amounts whose transfer to shareholders is restricted by a Court Scheme or other regulatory requirements and other identifiable components whose initial quantum can be established from the company's books and records and whose reversal can be tracked in those books and records – taxed/relieved on reversal
  - 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 – spread in accordance with that expected reversal pattern
  - Residual component – spread over a period of 10 years
- Specific transitional measures may also be required, for example to deal with contingent loans and FAFTS

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How many transitions?

- 1 January 2013 – Solvency II?
- 1 January 2013 – adoption of Solvency II liabilities for financial reporting
- 1 July 2013 – UK GAAP reporting ceases for publicly accountable companies including life assurance
- 1 January 2014 – effective date for IFRS phase II?

1 January 2013	1 July 2013	1 January 2014
Solvency II	End of UK GAAP	IFRS phase II

If the effective date for IFRS Phase II is later than that for Solvency II, the tax basis for life assurance in the UK will change twice – first from Solvency I to IFRS 4 or local GAAP, then from IFRS 4 or local GAAP to IFRS Phase II.

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IFRS Phase II for insurance contracts - timetable

- Supersedes IFRS 4
  - Issued 30 July 2010
  - Comments by 30 November 2010
  - IFRS Q2/11
- Effective date not yet confirmed

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IFRS Phase II for insurance contracts – salient features

- Insurance liability – presumed deductible
  - Best estimate future cash flows but not including tax
  - Discounting
  - Risk margin
  - Residual margin
- Acquisition costs – deductible when charged
  - Non-incremental
  - Incremental
- Unbundling – bifurcation
- Portfolio transfers and business combinations
- Transition – no residual margin

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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

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Taxation in a Solvency II world

Other UK tax policy issues

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Other UK tax policy issues

- Treatment of protection business being discussed with officials
  - Retain within I minus E
  - Include in GRB
  - Include with other long-term business
- Reducing volatility to be discussed with officials
  - Equalisation reserves
  - Averaging of profits
  - Exemption for capital movements in loan relationships
  - Carry forward of excess income
  - Carry back of excess expenses and losses over extended period
  - Group relief for expenses
- Effect of reductions in mainstream rate

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Taxation in a Solvency II world

QIS5 issues

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QIS5 issues

- SII base position
  - Policyholder tax allowed for in best estimate liabilities
  - Shareholder tax held outside of best estimate liabilities as DTL but typically modelled as 8% or 28% to the change in surplus and so misses the complex interactions with I-E and exempt dividends;
  - Change in level of deferred tax assets to reflect a shift in surplus (SI to SII) relative to the tax basis.
  - Change in level of deferred tax liabilities to reflect a shift in surplus (SI to SII) relative to the tax basis.

QIS5 issues

- DTAs and DTLs: spec refers to IAS 12 and international accounting standards. However two highly non market consistent aspects of IAS when it comes to valuing deferred tax assets and liabilities are:
  - no discounting is permitted
  - deferred tax asset or liability should be set up if the future cash flow is "probable" to arise i.e. greater than 50% probability
- SCR
  - loss absorbency of deferred taxes (DTL) in relation to trade profits to reduce SCR
  - Possible offset from new business or risk margin?

QIS5 issues

- Risk Margin makes an allowance for loss absorbency of deferred taxes in determining the SCR at time zero.
- Eligible capital
  - Net DTA's are Tier 3 capital as very illiquid asset
- Group tax relief
  - a new requirement that requires thought around the credit which can be taken for group relief between entities within the same period

Thank you

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