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Commercial Allocation of Income and Profit

Steven Graham



Life Tax Regime: Time for Change

Change was inevitable for the bespoke tax regime for life insurers:

- The regime formerly referenced the FSA Returns....
-and of course, Solvency II was going to be in place by 31 December 2012...
-so FSA Returns were going to change or be superseded
- If reference point no longer in place, don't have a basis for tax!

Therefore needed to re-write the tax regime:

- Tax regime re-write has a long lead-time
- Opportunity taken to overhaul/ simplify other aspects of regime.



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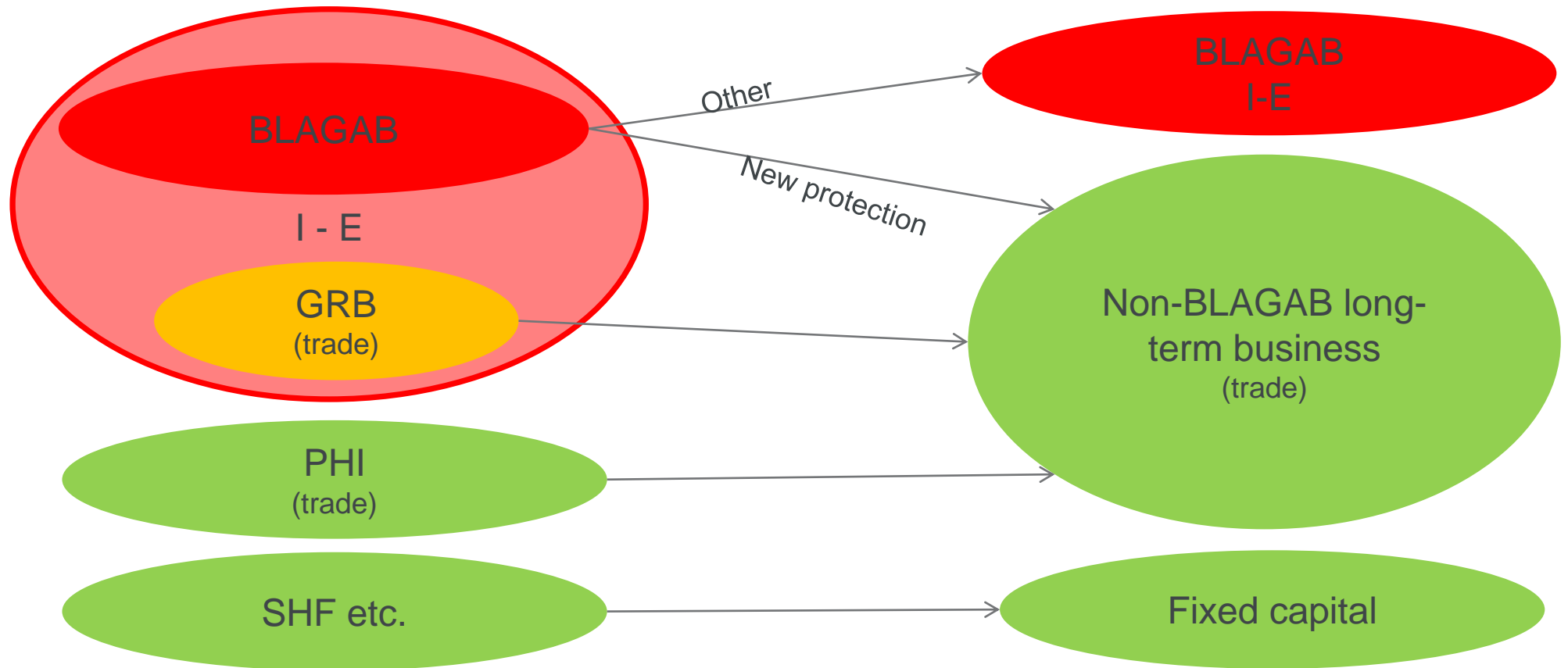
Life Tax Regime: Key Changes Implemented

Key changes to regime effective from 1 January 2013

New reference point	<ul style="list-style-type: none">• Accounts based, not FSA• UK GAAP or IFRS
Simplified tax categories	<ul style="list-style-type: none">• Previous categories reduced to two• Now BLAGAB, non BLAGAB
Commercial Allocation	<ul style="list-style-type: none">• Need to allocate between categories• Was formula, tax 100%?
Shareholder Fund	<ul style="list-style-type: none">• Long Term Business Fixed Capital• Is it a separate investment business?
New treatment of protection business	<ul style="list-style-type: none">• New protection treated as non BLAGAB• XSE synergy lost



Life Tax Regime: Change to Tax Categories



Commercial Allocation: Key Requirements

Need to allocate income, gains, profit to tax categories

Should reflect how business run

- Consider blocks of business
- NP, WP, linked, matched
- How are assets hypothecated to liabilities?

Freedom, not formula

- Old allocation used formula. Not always 100% tax/ sensible
- Now freedom to use own commercial allocation
- **However needs justified to HMRC**

Fair to tax categories?

- BLAGAB: does it get its fair share?
- Method really reflective of how run business?
- Not a tax avoidance mechanism?

Consistency of income, gains, profit

- Commercial allocations should be mutually consistent
- *Do not have to be identical*



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Commercial Allocation: How Could it Look?

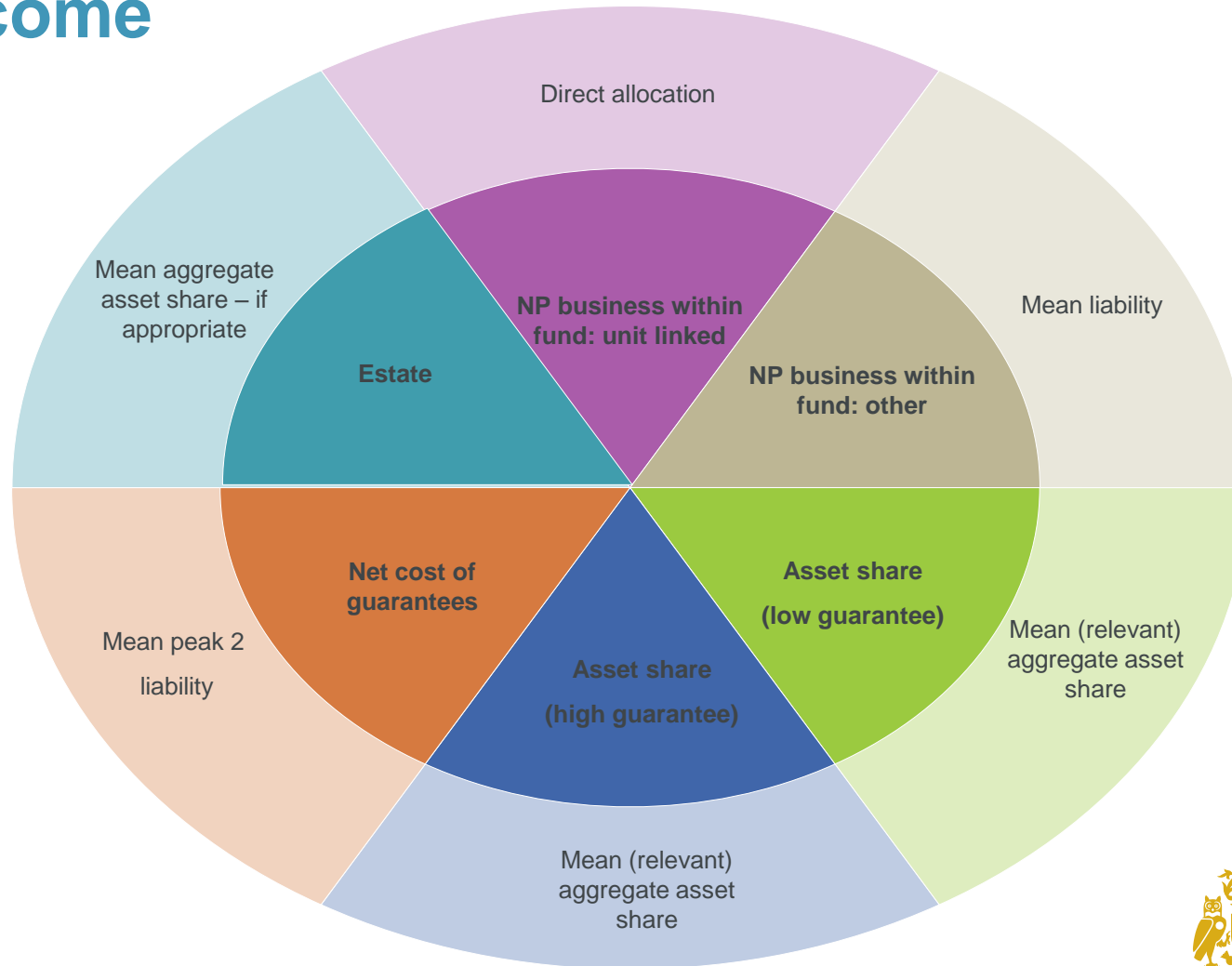
NP Income



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Commercial Allocation: How Could it Look?

WP Income



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Commercial Allocation: Gains

If have disposal, where do you allocate the gain?

- Generally similar method used to allocate gains as for income
- Gains on matched business are straightforward
- Method should fairly represent the contribution assets have made to the business during the period they have been held
 - But may not hold historic records for this
 - Desire to avoid detailed ‘archaeology’ of asset holding
 - Consider stability of tax category? Degree of asset turnover?
- Where significant disposal could cause a distortion
 - Such as large property held for many years.....
 - Would need to determine an ‘appropriate’ adjustment...
 - ...should also have a governance framework.



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Commercial Allocation: Trading Profit

Different approaches taken for NP/WP funds:

- NP
 - Consistent with approach for investment income
 - $P + I + G - E - \text{Claim} - \text{Increase in reserves}$
 - Premium, expenses, claims, reserves based on actual MI
 - Investment income / gains based on commercial allocations used.
- WP
 - Based on shareholder's share of WP bonus
 - If 90/10 fund, 1/9th of bonus
 - If Scheme of Demutualisation, can define level of bonus
 - Area where feedback changed guidance?
- Not an issue for mutual firms.



Commercial Allocation: Issues for WP Funds

Realistic Balance Sheet likely framework for WP commercial allocation:

- Asset Shares

- Retrospective accumulation of premiums, investment return, expenses, charges
- Mean asset share appropriate to allocate income for this year?
- Pragmatic approach
- Are there different sub-pools?

- WP Estate

- Key question: what is the estate being used for? To support fund as a whole, specific liabilities, or new business?
- Will be set out in the PPFM
- The liability used to allocate estate assets should mirror the use to which it is put.

- Area where could see complexity where have multiple WP funds.



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Commercial Allocation: Issues for NP Funds

NP funds not without their complications when developing a commercial allocation:

- Are the liabilities considered sufficiently granular?
 - Analysis of liability types needs to be sufficiently granular.....
 - Different classes of liability could have quite different tax profiles
 - The assets hypothecated to them could also be quite different
 - Lack of granularity could give an inappropriate tax allocation.
- Allocation of NP Surplus
 - Similar to WP Estate, key question on allocation of NP surplus assets relates to what use the surplus is being put to
 - Total mean liability unlikely to be appropriate, if there are significant unit linked liabilities
 - NP surplus more likely to support non linked liabilities
 -non linked mean liabilities more appropriate allocation factor?



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Commercial Allocation: Next Steps in the Short Run

New Regime effective 1/1/13, but computation is in arrear

- High level allocation methodology needs to be converted into detailed calculation
- A calculation process needs to be implemented, together with associated controls
- Should perform 'analysis of movement' – what is the impact on the tax bill, and is it understood?
- What are the main judgements made?
- New protection business already being written - systems in place for this?



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Commercial Allocation: Next Steps in the Longer Run

Commercial allocation should continue to reflect the way the business is run:

- Should require tweaking rather than re-writing of the methodology
- Range of factors could impact profile of assets/liabilities and hence allocation required:
 - Will be natural run-off of business - BLAGAB become less material, could simplify?
 - Part VII transfer in/ out?
 - Extension of ALM?
 - Branch into new market?
 - SII entity rationalisation?
 - No need to have separate annuity company?



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Commercial Allocation: Good Governance

Should have robust governance framework to ensure that commercial allocation remains aligned to way business is run:



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