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Tax – The beast that won't lie down

Andrew Rendell, Joe Collins and Matthew Taylor
of the Life Taxation Working Party

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Agenda

- Budget 2016 restrictions on carried forward losses and implications for the UK life industry;
- Tax efficiency and the relative attractiveness of BLAGAB;
- Tax update and current issues including:
  - Tax deductibility of corporate interest expense
  - VAT on claims management

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Budget 2016 restrictions on carried forward losses and implications for the UK life industry

Andrew Rendell

Proposed reforms on tax relief

Introduction

- The 2016 Budget introduced two proposed reforms, to be effective from 1 April 2017
- The change will impact most life companies but the materiality will depend on the individual firm’s tax characteristics
- The Tax Working Party has met with HM Treasury and assisted with the IFoA response to the consultation paper
- The outcome of the consultation remains uncertain at time of writing (October 2016)

Agenda

- Explain the changes
- Explain potential impact on insurers
- Summarise the IFoA response

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Summary of proposals

More group relief (the good news)

- Greater scope to access group relief over time
- Currently group relief only permitted in year of loss
- Proposed ability to allow group relief of carried forward losses

Reduced ability to offset losses (the bad news)

- Carried forward losses can currently be offset against future profits in that company
- Proposal is that losses can only be utilised against 50% of those profits

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Group relief

- Suppose a taxable loss arises in Year T in Company A. Company B within the same group makes profits every year

- Current relief against profits

Company	T-1	T	T+1, T+2…
A	Yes	Yes	Yes
B	No	Yes	No

- Proposed relief

Company	T-1	T	T+1, T+2…
A	Yes	Yes	Yes
B	No	Yes	Yes

- Potential benefit for actual year on year tax, particularly if A and B are exposed to different profit drivers
  - e.g. A = Annuity company provider, B = asset manager or management services company
- Potential benefit for recognising relief in Group SCR under internal model
  - But only if able to demonstrate reliability of available profits, for which PRA sets a high bar

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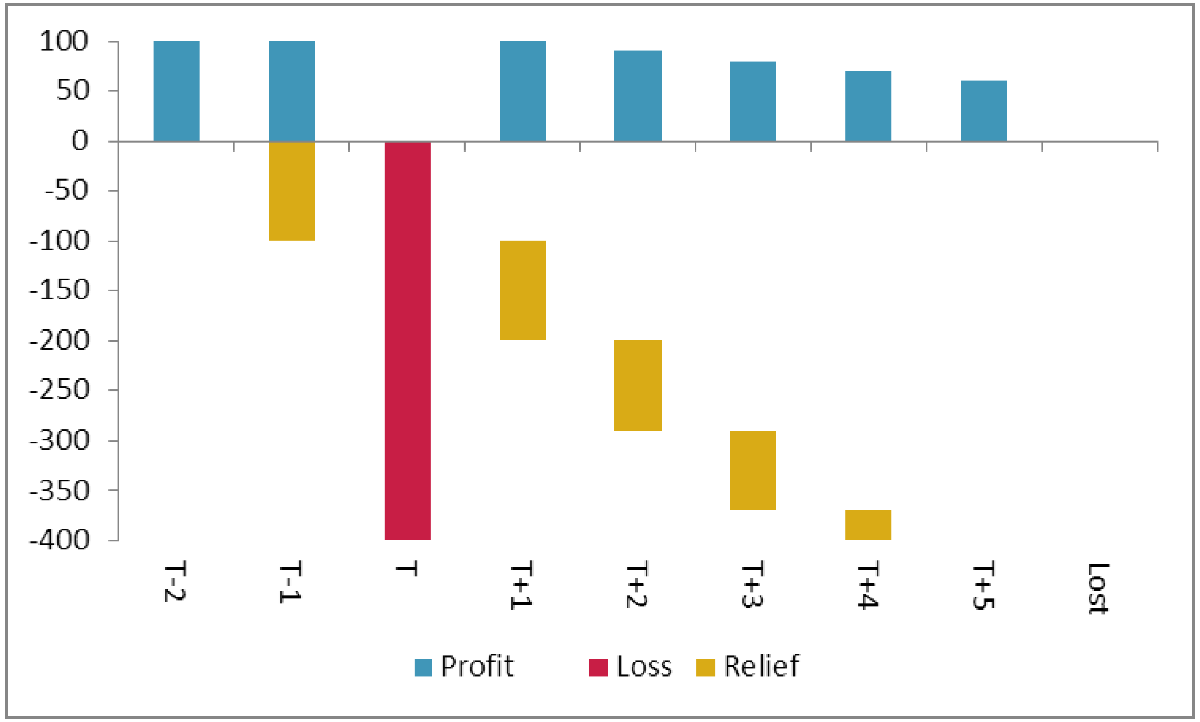
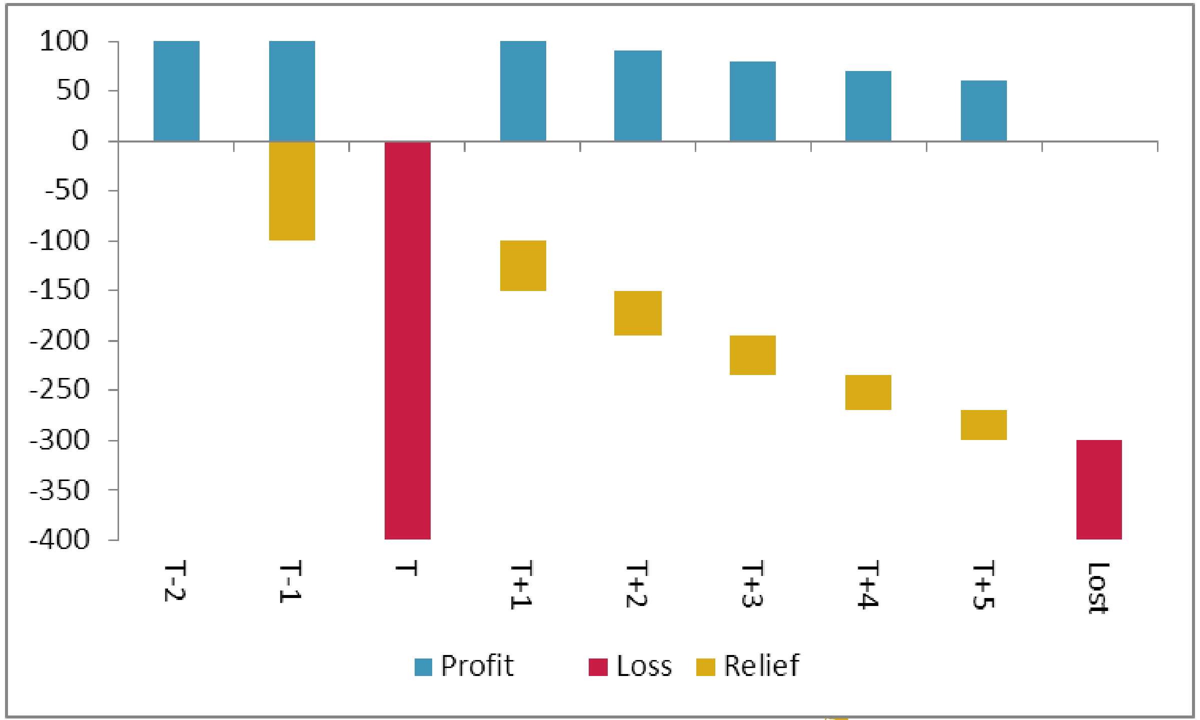
Use of future profits

- Charts illustrate the impact with 5 years of profits for simplicity but losses can be carried forward indefinitely
- Under the proposals, only £5m per group plus 50% of any balance of profits can be offset by losses carried forward from earlier years

Current



Proposed



The chart of the proposed taxation approach shows how losses will be left unutilised for longer than currently. This will risk losses never being utilised and so will reduce the value of deferred tax assets

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Impact on SCR - background

- SCR event envisages a large loss occurring within a one year period
- SCR loss can be mitigated by tax relief through the Loss Absorbency Capacity of Deferred Tax (LACDT)
- LACDT needs to be justified through an assessment of future profits against which to obtain relief
- There is no time value discounting of deferred tax assets (or liabilities)
- Sources of profit used will vary with the firm's characteristics and its ability to evidence the profit source robustly
- Examples of profits and deferred tax liabilities shown below (not exhaustive)

Profits arising in future years
New business profits
Real world returns
Returns on surplus
Contract boundary effects

Deferred tax liabilities
Spreading from 2013 tax rule changes (IFRS vs peak 1 liabilities)
Temporary timing differences (SII liabilities vs IFRS liabilities)
Value of shareholder transfers on WP business

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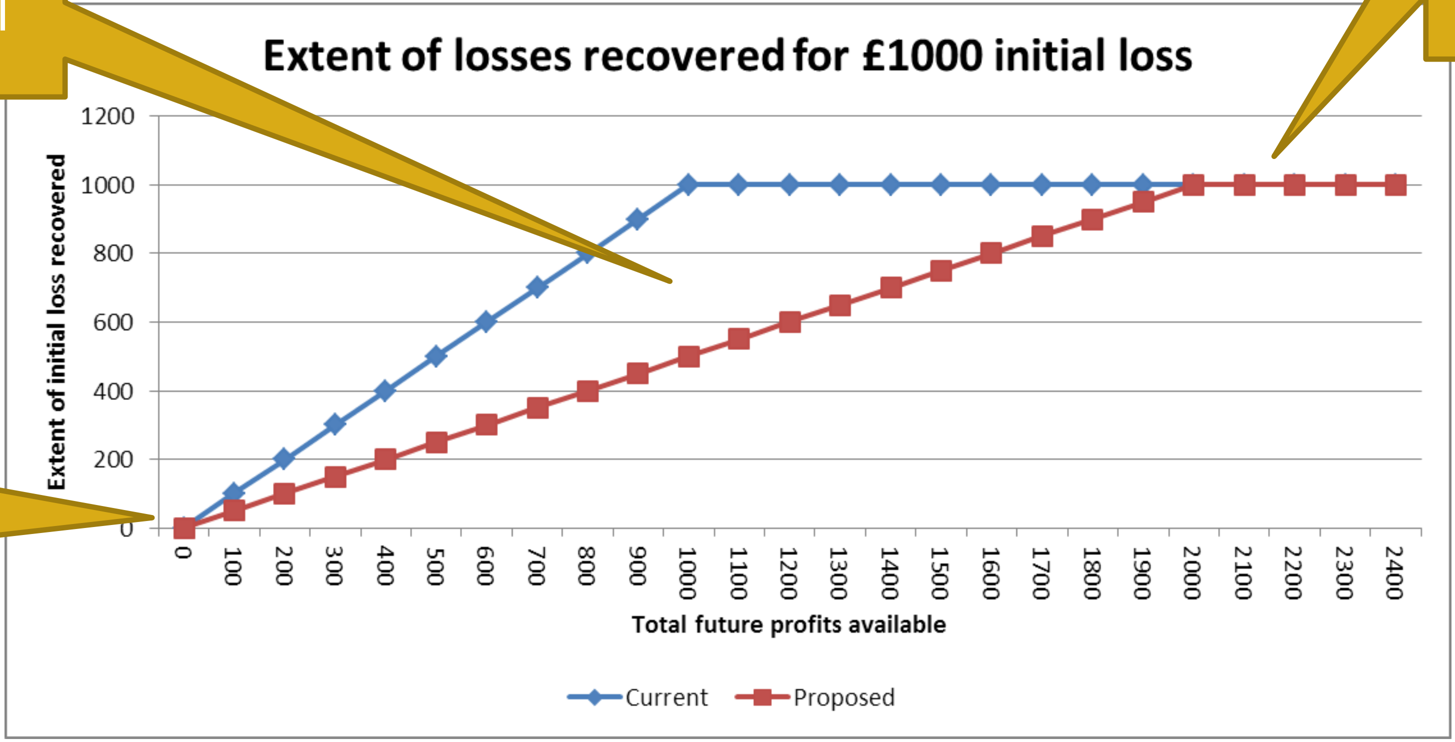
Impact depends on future profits vs loss

- Graph shows extent of relief for £1000 loss depending on the amount of future profits

Most impact when total future profits = initial loss

No profit = no impact !!

Lots of profit = no impact (it takes longer to gain relief but LACDT is not discounted)



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What the HMT consultation said

Introduction

- Carried forward losses are of significance to insurers
- The 50% restriction could reduce DTA's
- The 50% restriction could increase the SCR and reduce a firm's solvency ratio

- "The government would like to understand the **materiality** of these impacts and the extent to which insurers will need to take **mitigating action** in order to ensure that regulatory capital requirements are adhered to."

- It would also like to understand ways in which the impact on insurers' regulatory capital could be mitigated through the **detailed design** of the reforms, while noting the **significant policy and legal challenges** in making these detailed changes **specific to the insurance sector**.

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What the Tax Working Party has done

We met with HM Treasury in July 2016 to help explain the impact on insurers and discuss potential mitigants

We assisted with the IFoA's formal response to the HMT consultation, with the following key messages

- The proposals will increase capital requirements
- Limitation of relief is contrary to principle of insurers pooling risk over time
- Impact most prevalent for life insurers due to long term nature of contracts (but can impact general insurers too)
- Impact accentuated by regulatory regime which capitalises assumption changes
- Capital increases could increase new business premiums through consequential increase in cost of capital
- Potential modifications to mitigate impact:
  - Ring fence insurers from the proposed rules
  - Apply different rules for long term contracts (whether insurance or otherwise)
  - Apply averaging approach to determine taxable profit in each year

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What happens next

- There was a considerable reaction to the proposals, from other industries as well as insurers
- BREXIT may prove a distraction to policymakers!
- BREXIT also adds focus to the wish for the UK to attract/retain business

- There is no specific timeline for HMT to feed back from the consultation process
- The Autumn Statement may give an indication of whether these proposals remain a priority
- Otherwise, draft legislation is due on 5 December

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Tax efficiency and the relative attractiveness of BLAGAB

Joe Collins

Taxation of insurance policies vs direct investment

- The taxation of contracts entered into with insurance companies is set out in the "Insurance Policyholder Taxation Manual" (IPTM)
- This includes the taxation of "investment bonds" which are essentially vehicles for investing in assets under the auspices of an insurance policy (source: IPTM 1100 "An investment rather than insurance in the general sense")
- We compare the taxation of the proceeds of an investment bond to the taxation of the proceeds from direct investment in assets, for two simplified scenarios – 100% equity investment and 100% corporate bond investment
- No clear indication of whether or not an insurance policy is more or less efficient than direct investment, in the case of equities.
- Potentially inefficient if investing in corporate bonds.

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Taxation of insurance policies

- Investment bonds are taxed on a “chargeable events” basis.
- Broadly, over its lifetime, the total charges on the policy are expected to relate to the net gain upon it, namely, the difference between benefits received and premiums paid.
- The gains from the bond will be treated as income, and the policyholder will generally be treated as though income tax at the basic rate has already been paid - this reflects the tax paid by a UK-resident insurer attributable to the income and gains arising on assets backing policyholder benefits
- The insurer is charged tax on an “I-E” basis, at the basic policyholder tax rate (currently 20%), with dividends being exempt and an indexation allowance for capital gains.

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Taxation of direct investment

- Equities
  - Dividend income is taxed using a specific “dividend income” rate, based on taxpayer status
  - Capital gains charged as capital gains

- Corporate Bonds
  - Interest payments treated as income, and taxed accordingly
  - The majority of sterling bonds are free from capital gains tax, providing that they are "Qualifying Corporate Bonds“ (source: Hargreaves Lansdowne investor advice).

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Relative tax efficiencies

These are examples. The relative tax efficiency depends on the tax circumstances for each individual

- ## Equities

	Basic rate tax payer	
	Direct	Insurance
Type of tax		
Dividend	7.5%	0.0%
Gains	10.0%	20.0%

	Higher rate tax payer	
	Direct	Insurance
Type of tax		
Dividend	32.5%	20.0%
Gains	20.0%	36.0%

- ## Corporate Bonds

	Basic rate tax payer	
	Direct	Insurance
Type of tax		
Interest payment	20.0%	20.0%
Gains	0.0%	20.0%

	Higher rate tax payer	
	Direct	Insurance
Type of tax		
Interest payment	40.0%	36.0%
Gains	0.0%	36.0%

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Tax update and current issues

Matthew Taylor

Tax update and current issues - agenda

- Tax deductibility of interest payable
- VAT on claims management
- Consultations and other issues

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Deductibility of interest payable – current position

- Interest payable is generally deductible for UK corporation tax unless
  - it is for an "unallowable" tax avoidance purpose
  - it is to a connected party and is in excess of an arm's-length amount
- Indefinite carry forward of unrelieved interest in paying company
- Deductible interest transfers the taxation of profit from the paying company to the recipient and is a form of profit shifting
- Base erosion and profit shifting ("BEPS") has been the subject of several studies by the Organisation for Economic Co-operation and Development ("OECD") leading to recommendations for changes to the tax regimes of member jurisdictions including interest deductibility (action 4)

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Deductibility of interest payable – general proposals

De minimis threshold	All groups will be able to deduct up to £2m net UK interest expense
Fixed ratio rule	Cap on deductible net interest expense of 30% of UK 'tax-EBITDA'
or	
Group ratio rule	Optional higher deduction based on group ratio
and	
Modified debt cap rule	Net interest deduction cannot exceed global **net** adjusted group interest expense
Rules to address volatility	Indefinite carry forward of disallowed interest three year carry forward of excess capacity

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Deductibility of interest payable - timetable

October 2015	OECD Final Action 4 report on interest deductibility
October 2015 - January 2016	First UK Consultation
March 2016	UK Budget and Corporate Tax roadmap Announcement that UK will implement Action 4 from 1 April 2017
12 May 2016	Second UK consultation
28 July 2016	OECD published ‘Approaches to address BEPS involving interest in the Banking and Insurance sectors’
4 August 2016	Second UK consultation closes
8 September 2016	Deadline for comments to OECD paper
October 2016	OECD approach to banks/insurers finalised
December 2016	Draft UK legislation?
1 April 2017	UK legislation to become effective

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Deductibility of interest payable - EBITDA

EBITDA = earnings before interest, tax, depreciation and amortisation - proxy for earnings from the underlying business

Many financial institutions including insurance companies have net interest receivable

A rule based on disallowing part of net interest payable has no impact on companies with net interest receivable

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OECD consultation –banks and insurers

OECD Action 4 discussion draft published 28 July 2016

- The Draft:
  - Suggests limitations to extent regulation prevents BEPS
  - Suggests “hybrid” capital could pose risks where regulation would not constrain tax deductible interest
  - Addresses risks on attribution of free capital to permanent establishments
  - Considers impact of funding equity investments producing exempt returns
- Recognises that material BEPS risk from excessive leverage in banks / insurers unlikely to be an issue

No need and no clear recommendations for single common approach

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Interest deductibility - solo regulated entity carve out

- Solo regulated entities could be excluded from the fixed ratio rule, while still applying the rule to other group entities
- Using group ratio rule, interest limit will in this case be the amount of net qualifying group-interest expense
- UK consultation suggests two measures if the resulting interest capacity is deemed "excessive" compared to UK activity:
  - **Option 1:** groups may utilise only their current year financing costs
  - **Option 2:** the limit may be capped at a fixed percentage of tax-EBITDA

Interest deductibility under fixed ratio rule would be limited to non regulated entities

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Deductibility of interest payable – group ratio rule

Worldwide debt cap legislation repealed - worldwide debt cap based on gross interest payable

Amounts due to related parties included in group interest expense (unlike fixed ratio rule)

Unclear whether carve-out for “Qualifying financial services groups” where “substantially all” income is from “qualifying activities” will be replicated in modified rule

Net deductible amounts cannot exceed global net adjusted group interest expense

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Interest deductibility - summary

- No grandfathering except in exceptional circumstances
- Public benefit test
- Specific considerations for various industries. Two possibilities in consultation for modified/bespoke rules for banking and insurance:
  - Exclude interest and EBITDA of “banking and insurance companies”. Broad carve-out for banking and insurance groups apparently rejected
  - Targeted anti-abuse rule “to restrict relief in certain situations to ensure net financing costs deducted in the UK are commensurate with the UK business”
- Targeted anti-avoidance rules

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Interest deductibility - industry perspective

- Substantial dialogue between Industry, HMT and HMRC to highlight concerns
- If implemented as proposed, could cause issues with deductibility
- What are true aims of proposal
  - To allow a deduction for borrowings used to fund UK profits?
  - Restrict the use of UK interest to fund overseas purchases?
- Will we get a sensible conclusion which is right for both industry and Government?

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VAT on claims management - CJEU

- Staatssecretaris van Financiën v Arthur Andersen & Co. Accountants c.s. (ECJ 3 March 2005 C-472/03)
  - ‘back office' activities, consisting in rendering services, for payment, to an insurance company do not constitute the performance of services relating to insurance transactions carried out by an insurance broker or an insurance agent within the uniform basis of assessment
- Minister Finansów v Aspiro SA (ECJ 17 March 2016 C-40/15) on VAT on outsourcing of insurance administration has confirmed this view for claims settlement services provided by a third party in the name and on behalf of an insurance company
  - activities must cover "the essential aspects of the work of an insurance agent", such as the finding of prospective clients and their introduction to the insurer

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VAT on claims management – UK position

- UK VAT legislation exempts the provision of assistance in the administration and performance of such contracts, including the handling of claims and the collection of premiums. This is inconsistent with the judgments of the CJEU
- If it were to have remained in the EU, the UK would have been among the member states which would have to re-consider the way it taxes these transactions in light of the judgment. This may not now be necessary
- The outcome here will be of specific interest to the actuarial profession in determining technical provisions for the financial statements and Solvency II balance sheets and those seeking to value long-term businesses for transactions who will need to incorporate any change in their modelling.

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Consultations and other issues

- Consultations:
  - Personal Portfolio Bonds
  - Authorised Contractual Schemes
  - Part surrenders
  - Secondary Annuity Market
- Other issues:
  - Corporate criminal offence for facilitating tax evasion
  - Corporate streaming
  - Reinsurance regulations
  - Reduction of corporation tax rate (2017)

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Consultations

Personal Portfolio Bonds	More investments to be permitted
Authorised Contractual Schemes	Provisions for dealing with capital allowances on real estate within authorised contractual schemes
Part surrenders	Measure to remove excessive taxation on part surrenders in excess of 5% annual limit
Secondary Annuity Market	Potential regime for taxing purchases and sales

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Other issues

Corporate criminal offence for facilitating tax evasion	Applies to agents. Requirement for systems and controls analogous to money laundering
Corporate streaming	Restriction of tax credit by reference to tax suffered by the fund
Reinsurance regulations	Updating of regulations imputing investment return to cedants where BLAGAB investments are reinsured
Reduction of corporation tax rate (2017)	19%

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Questions

Comments

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