The Actuarial Profession
making financial sense of the future

1 January 2013 – Are you ready?
Paul Turnbull, Matthew Taylor,

Forthcoming changes in the life taxation regime

6 November 2012

Agenda

- Overview – Paul Turnbull
- Protection – Matthew Taylor
- Allocation – Paul Turnbull
- Modelling – Paul Turnbull and Matthew Taylor
- Transition – Matthew Taylor

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Overview

Classes of business and basis of taxation

- Current legislation in the Income and Corporation Taxes Act 1988 and Finance Act 1989
- Long-term business is separated into three tax categories:
  - Basic life assurance and general annuity business (“BLAGAB”)
  - Gross roll-up business (“GRB”)
  - Permanent Health Insurance (“PHI”)
- BLAGAB taxed on an I minus E basis
- GRB taxed on a trading profits basis derived from the actuarial surplus in the FSA Returns
- Aggregate of the above subject to a minimum profit based test again based on the actuarial surplus in the FSA Returns – life assurance trade profit (“LATP”)
- PHI taxed separately on trading profits based on the financial statements in the accounts

Rationale for the I minus E basis

- The I minus E basis for taxation does have some logic

A company's incomings and outgoings consist of:

Premiums	P
Investment income & gains	I
Expenses	E
Claims	C

Shareholders' profit (SP) expressed as P + I - E - C = I - E - (C - P)

Policyholders' return (PP) is difference between claims and premiums

so PP = C - P so SP = I - E - (PP)

so I - E = SP + PP

I minus E correctly taxes the sum of shareholder and policyholder profits

Background to the changes

- Changes were prompted by Solvency II
- Existing FSA Returns will disappear
- Over two years of consultation between
  - HMRC
  - HMT
  - Life assurance industry
  - Advisors
- Legislation is part 2 of FA 2012
- “A considerable simplification of the life assurance tax regime”
- Still runs to 95 sections and 2 schedules
- Will come into effect from 1 January 2013

Loss of FSA returns made change inevitable

Principal features of the new tax regime

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

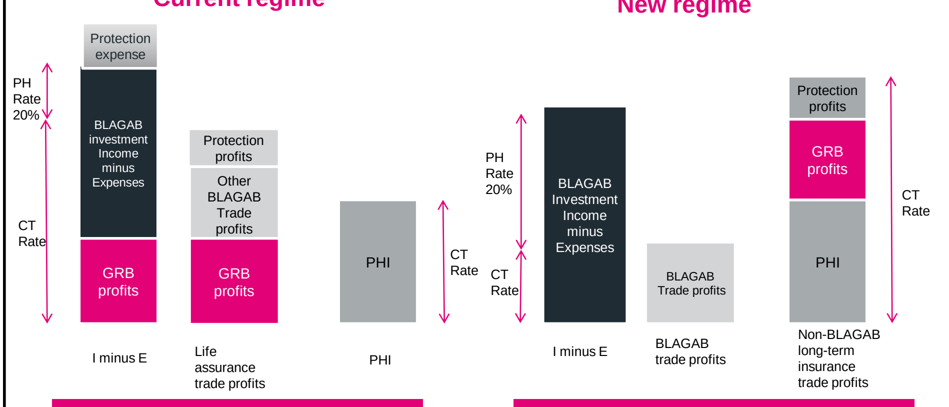
Remain the same

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

Transition

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

I minus E and trade profits computations



I minus E reduced by protection expenses and policyholder tax by protection profits

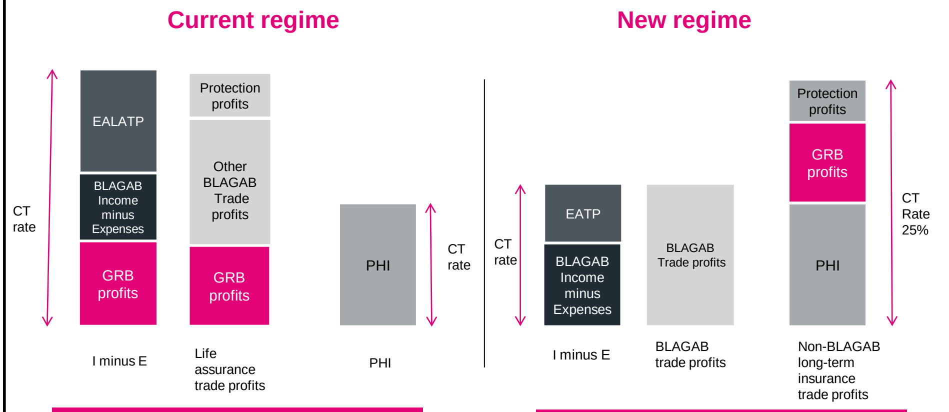
No protection expenses. Protection profits not in I minus E so do not reduce policyholder tax

Key

PHI – Permanent Health Insurance
GRB – Gross roll-up business
BLAGAB – Basic Life Assurance and General Annuity Business

CT – Corporation Tax
PH - Policyholder

I minus E and trade profits computations (continued)



EALATP increased by protection expenses and protection profits

BLAGAB EATP independent of protection expenses and protection profits

Key

EALATP – Excess adjusted life assurance trade profits
GRB – Gross roll-up business
BLAGAB – Basic Life Assurance and General Annuity Business

PHI – Permanent Health Insurance
CT – Corporation Tax
PH - Policyholder

Impact on firms - Basis of taxation

Trading profits

- Managing IFRS profits becomes more important
- Taxable profits may be more volatile
  - especially for with profit companies with supporting non profit funds on which profits are currently smoothed via Form 14 investment reserves
- Modelling difficulties – are companies going to move from modelling peak 1 to IFRS reserves giving the impending changes to IFRS Phase II?

Merging PHI and GRB

- Enables 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 currently be group relieved against PHI profits but not against GRB profits
- But, no transitional “streaming” rules so existing losses can be offset against profits from either source

Taxable profits more volatile. Loss relief pattern different

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Protection

Protection product pricing

	Old regime			New
	No Tax	XSI co.	XSE co.	regime
Risk premium per annum	100.0	100.0	100.0	100.0
Investment return	5.0	5.0	5.0	5.0
Annual expense	40.0	40.0	40.0	40.0
Policyholder tax	-	- 7.0	-	-
Profit before sh tax	21.3	22.0	27.7	27.7
Shareholder tax	-	0.7	6.4	6.4
Net profit	21.3	21.3	21.3	21.3
Annual premium	**156.3**	**150.0**	**162.7**	**162.7**

- Most protection business creates more expenses than investment income
- “Excess I” companies currently gain by offsetting the excess expenses against income elsewhere
- “Excess I” companies can also use tax on I from other products to reduce the effective rate of tax on protection profits to the excess of the mainstream rate over the basic rate
- Taxing new protection business on a profits basis will level the playing field, but potentially result in higher prices to consumers

No expenses from new protection business
Protection premiums may increase

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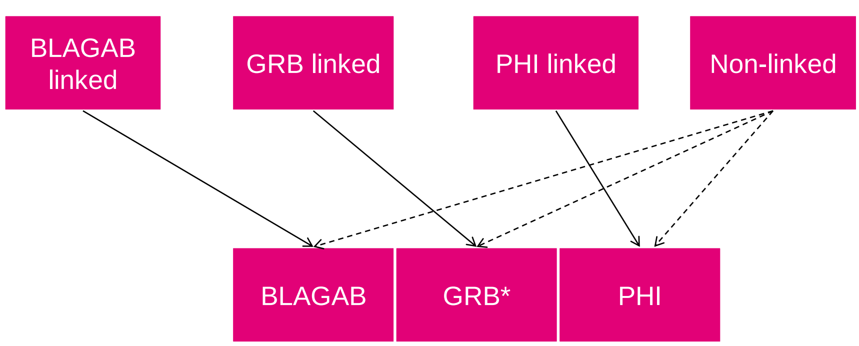
Allocation

Current rules - apportionment



Apportioned in accordance with a liability method
GRB in with-profit funds allocated by 'needs basis'

Apportionment - example

Apportionment of income rules do not always take account of assets backing each product and although particular taxation may be assumed for investments in pricing and reserving, the taxation may in fact be different.

Assume a with-profits fund with:

- £100m of BLAGAB With-Profits
- £100m of GRU With-Profits
- £100m GRU annuities

And assets:

- £100m of gilts matching protection and annuities – 5% return
- £200m of equities matching with-profits – dividends 3% growth 2% (RPI 3%)

Apportionment - example

Ideal allocation	Gilt Income	Equity Income	Tax
£100m of BLAGAB With-Profits	0.00	5.00	0.00
£100m of GRU With-Profits	0.00	5.00	0.00
£100m GRU annuities	5.00	0.00	0.00
Total			0.00
Apportioned allocation			
£100m of BLAGAB With-Profits	1.66	3.33	0.33
£100m of GRU With-Profits	1.66	3.33	0.00
£100m GRU annuities	1.66	3.33	0.00
Total			0.33

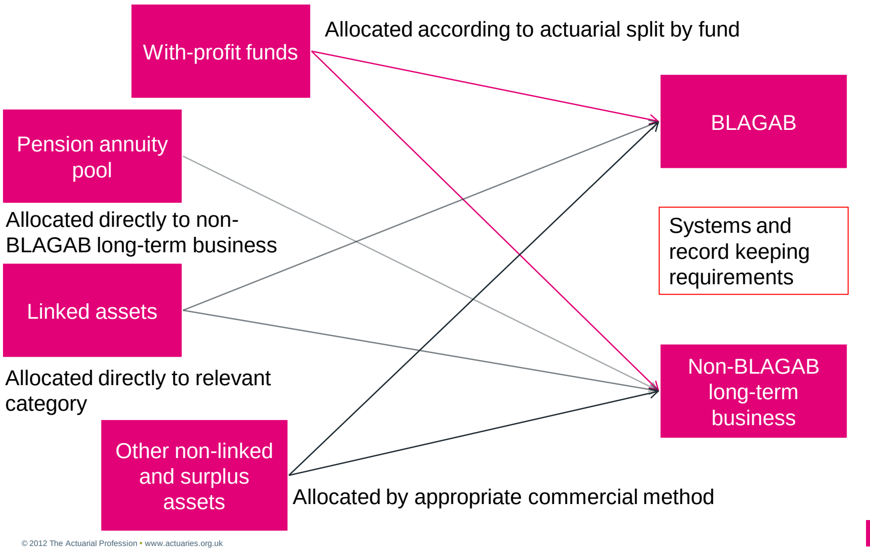
Apportionment distorts income allocation

Allocations - Principal changes

- Current statutory apportionment rules for investment returns cease
- New regime requires investment income, gains and profits to be allocated between BLAGAB and OLTB on a commercial basis
- Acceptance that this may still require some sub-allocation on a formulaic basis
- Requires companies to agree the approach with the HMRC
- HMT has regulation-making power to limit possible allocations
- Consistency between the allocation of income and gains, and of trading profits
- For with-profit business the pre-tax profit can be allocated pro rata to bonuses, or possibly fees on UWP business
- Direct attribution of fiscal adjustment to result in allocation of 100% of taxable profits

Commercial allocation now required

New rules – allocation of income



Income allocation - issues

- In practice the approach a company takes to allocation will depend on the business it writes.
- Variety of different allocation methodologies available.
- Groups need to agree on appropriate method, document and agree with CRM.
- Potential for optimisation depending upon how different types of income are commercially allocated
- How are these assets actually managed?
- What is the optimal allocation methodology?

Understand how assets are managed and matched and agree with HMRC

New rules – allocation of chargeable gains

Non-BLAGAB linked /matched

Direct allocation

BLAGAB linked /matched

Direct allocation

With profit fund 1

With profit fund 2

In proportion to actuarial split by fund?

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

New rules – chargeable gains pools and boxes

Capital gains boxes (section 440 ICTA 1988)

(a) **Assets linked or matched to Non-BLAGAB long-term business**

Exempt

(d) **Assets linked or matched to BLAGAB**

Taxable

(e) **With-profit fund 1**

With-profit fund 2

Balance of trade assets

(f) **Life assurance fixed capital**

Deemed disposal at market value for inter-box transfers rolled over into base cost

Section 171 of the Taxation of Chargeable Gains Act ("TCGA") 1992 disapplied for (a), (d) and (e)

Number of (e) boxes will depend upon commercial approach taken by company to management of investments

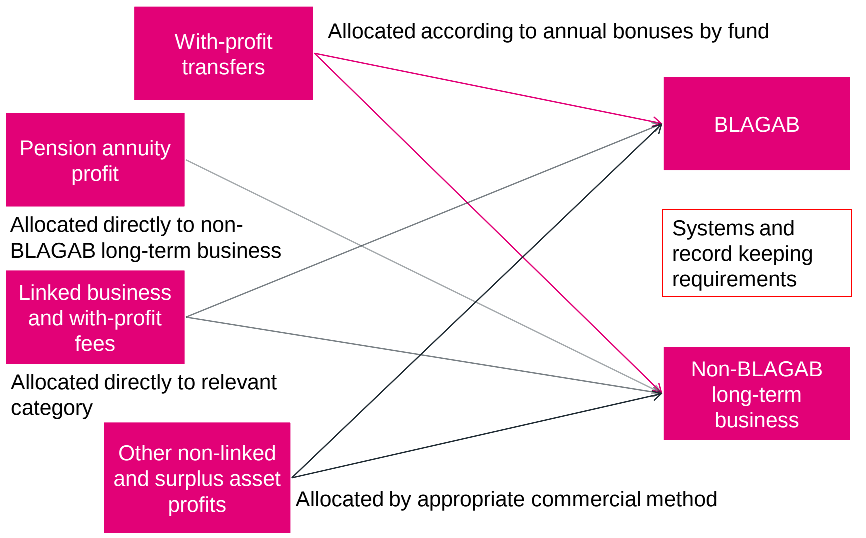
May be governed instead by section 161 TCGA 1992

Gains allocation - issues

- Gains on "matched" assets are directly allocated
- For other assets, method must "fairly represent" contribution that assets have made to BLAGAB during the period for which they have been held
- Allocation does not need to be the same for all assets in a "box" but could be bespoke to a specific asset
- There could be issues allocating the corporate capital gains base cost between the new boxes and pools
- Can consistency be achieved with income allocation?

Some CRMs want a more detailed approach to the history of the contribution of assets than others

New rules - allocation of profits



Impact on firms - Allocation

- 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!

Need to include new commercial allocation approach in tax projections at year-end 2012 and business as usual at Q1 and H1 2013

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Modelling

When to model

- Solvency I
- Embedded values
- Part VII transfers
- Pricing
- Solvency II

Reminder on how deferred tax is "calculated" currently

Current tax — Tax computation

Tax value differences, e.g. BLAGAB unrealised gains

Current tax and some deferred tax — FSA return

Accounting value differences, e.g. DAC, sterling reserves

Current tax and all deferred tax — Financial Statements

Deferred tax reflects temporary differences from the tax computation

Deferred tax projections

Temporary difference	Projection required
BLAGAB matters: • Excess E • Deferred acquisition E	Projected BLAGAB income in excess of BLAGAB trade profits
• Realised capital losses • Spread losses	Projected chargeable gains
• Spread gains • Unrealised chargeable gains	Pattern of realisation
BLAGAB trade losses Non-BLAGAB trade losses	Projected financial statement profits with commercial allocation

Except for MCEV, projections for tax should use "real world" rates of return

Solvency I - rules

Rules

- Deferred tax assets are inadmissible unless they are linked assets whose value is included in a unit-linked fund
- Deferred tax provisions on unit-linked business may be included in mathematical reserves
- Other deferred tax provisions shown in Form 14 line 21

Solvency I - impact

Current position

As trade profits are based on Solvency I surplus, only I minus E items generally considered. Conservatism in FSA return will tend to result in current tax relief

2013 position

As trade profits are based on financial statements, differences in profit recognition need to be considered. Relative conservatism in FSA return will tend to result in inadmissible deferred tax assets

Solvency I capital may be reduced

Embedded value considerations

- Tax projections need to be on a financial accounting basis
- Projected BLAGAB income and gains need matching to:
  - Excess and deferred expenses of management
  - Realised, spread and unrealised capital losses
  - BLAGAB trade profits in excess of projected BLAGAB exempt dividends
- For MCEV assumptions need to be made about the tax treatment of risk free returns either:
  - Scale down each component of real world rate, or
  - Assume equity return is from dividends before gains
- Remember that the movement in the period in deferred tax balances on BLAGAB matters is itself an adjustment to BLAGAB trade profit

An insufficiency of projected BLAGAB income and gains means that some deferred tax assets cannot be valued and some BLAGAB profits are taxed at the full corporation tax rate

Part VII transfers

- Projections need to be on a financial accounting basis
- Accounting for the transfer needs to be determined in advance
- 3rd party transfers follow the financial statements:
  - Profits and losses fall into tax
  - PVIF is recognised for tax and future amortisation deductible
- Intra-group transfers are tax neutral but differences in reported values of assets and liabilities are aggregated and included as profits or losses in the transferee
- Transfers between with-profit and non-profit funds are treated as 3rd party

Need to understand accounting

New product pricing and pricing reviews

Key changes for product pricing teams

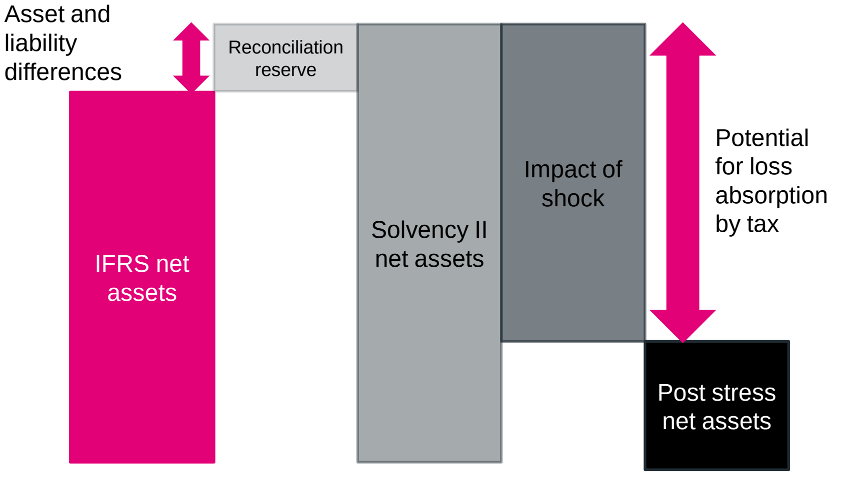
- Attribution of income and gains - must follow commercial allocation basis agreed with HMRC
- Protection business - now gross business - no more relief on expenses
- Tax follows IFRS results - which differs from modelling for Solvency II capital requirements

Additional changes for managing existing business

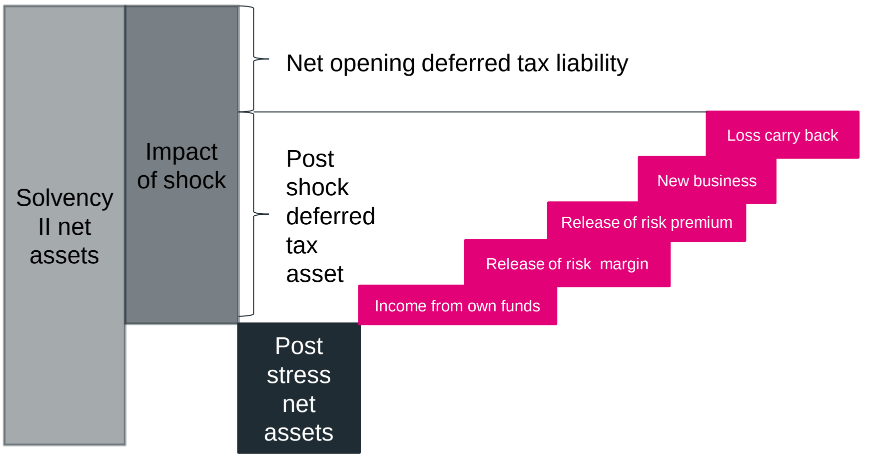
- Tax assets provide an offset to risk based capital requirements
- The value of existing tax assets may change due to the possible acceleration of relief
  - existing unrelieved expenses / excess adjusted trade profits
  - life assurance trade and gross roll-up business losses

Tax may affect modelling results from unanticipated sources

IFRS v Solvency II



Solvency II loss absorbency



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Transition

Total transitional difference - mechanics

Amount attributed to shareholders

Capital and reserves and fund for future appropriations at Form 14 line 75

Less

Fund for future appropriations – unallocated divisible surplus

LESS

Cumulative taxed surplus

Surplus carried forward at Form 14 line 13

Plus

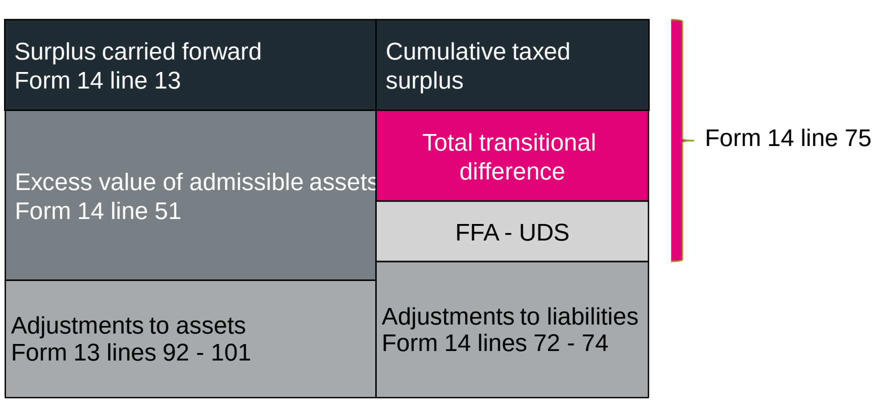
Investment reserve amounts not tax effective

Less

Undistributed demutualisation surplus

Accounts basis of long-term fund less statutory basis of long-term fund

Rationale for total transitional difference



Arithmetic proof of difference

HMRC categories - I

Amounts shown in the 2012 Periodical Return	Amounts shown in the 2012 Balance Sheet
1. None	• Deferred acquisition costs et c
2. None	• Present value of in-force business
3. None	• Loan liabilities where receipt of the loan was brought into account in Form 40 Line 15
4. None	• Liabilities under Financial Reinsurance arrangements
5. None	• Intangible assets which would be within Part 8 of CTA 2009 (intangible fixed assets)
6. Structural assets in non-profit funds within section 83XA of the Finance Act 1989 (structural assets) plus any reductions since 2006 not added back to trade profits	• Structural assets in non-profit funds within section 83XA of the Finance Act 1989

HMRC categories - II

Amounts shown in the 2012 Periodical Return	Amounts shown in the 2012 Balance Sheet
7. None	• Deferred income reserves
8. Form 14 line 21 plus any deferred tax provisions in mathematical reserves	• Net deferred tax liability arising from I-E tax attributes
9. Amounts that are not taxable or not deductible under Part 3 of CTA 2009 (Trading Income) as that Part applies to insurance companies	• Equivalent amounts that are not taxable or not deductible under Part 3 of CTA 2009 as that Part applies to insurance companies
10. Amounts the taxability or deductibility, or the timing of that taxability or deductibility, in computing trade profits, before and after the transition, are determined by specific tax rules rather than by any regulatory return or accounts entry, providing that the same rules apply both before and after the transition	• Equivalent amounts the taxability or deductibility, or the timing of the taxability or deductibility, in computing trade profits, before and after the transition, are determined by specific tax rules rather than by any regulatory return or accounts entry, providing that the same rules apply both before and after the transition

HMRC categories - III

Amounts shown in the 2012 Periodical Return	Amounts shown in the 2012 Balance Sheet
11. Linked asset (or part asset) values	• Linked asset (or part asset) values
12. Mathematical reserves less any deferred tax provisions	• Technical provisions less any deferred tax provisions
13. Form 14 Line 51 amounts relating to with-profits funds	• Fund for future appropriations or the unallocated divisible surplus
14. Form 14 Line 51 amounts relating to non-profit funds plus any reductions in structural assets since 2006 not added back to trade profits and less any unrecognised capital amounts and amounts not deducted on account of section 83YA FA 1989	• None
15. Deferred tax assets in mathematical reserves	• Net deferred tax assets arising from I-E tax attributes
16. Amounts not specified in any other category referable to policies	• Equivalent amounts not specified in any other category
17. Amounts not specified in any other category	• Amounts not specified in any other category

Excluded items - statute

Item	Rationale
• Deferred acquisition costs	• No change to timing of deduction
• Value of future profits	• No change to timing of charge
• Contingent loans	• Exemption matched to non-recognition of profit
• Financing reinsurance	• Exemption matched to non-recognition of profit
• FAFTs	• Relief for repayment or recapture of reinsurance
• Intangibles	• No relief for amortisation

Excluded items - regulations

Item	Rationale
Structural assets in non-profit funds within section 83XA of the Finance Act 1989	Already on accounts basis
Deferred income reserves	No tax on amortisation
Net deferred tax liabilities arising from I-E tax attributes	Relief not required
Amounts that are not taxable or not deductible under Part 3 of CTA 2009 (Trading Income) as that Part applies to insurance companies	Not taxable
Amounts the taxability or deductibility, or the timing of that taxability or deductibility, in computing trade profits, before and after the transition, are determined by specific tax rules rather than by any regulatory return or accounts entry, providing that the same rules apply both before and after the transition	No change to tax rules or basis

Apportionment of relevant computational items

General principle

- Use current basis of allocation
- Direct attribution for linked asset amounts, liabilities and FAFTs
- "Needs basis" and section 432C ICTA 1988 for value differences

Which amounts

- Only applies to relevant computational items
- Does not apply to excluded items
- Separate determination for each with-profit fund and the non-profit fund

Allocation should be the same as that used to determine deferred tax on acceleration of profits under current regime to minimise impact on reported profits

Deemed receipts and expenses

- Affect both BLAGAB and non-BLAGAB trade profit computations
- Positive relevant computational items are added to trade profits as deemed receipts
- Negative relevant computational items are subtracted from trade profits as deemed expenses

Predictable impact can be taken into account in loss planning

Timing of adjustment

- Impact spread in equal instalments over ten years 2013 to 2022
- Unless,
  - relates to amount in a non-profit fund the distribution of which is prohibited by a court order when deemed receipts deferred by up to 2 years (ie to 2015 to 2024)
  - transfer of business to a non-group transferee, or other cessation of category of business when remaining relevant computational items brought in as receipts or expenses immediately
- But
  - spreading continues where there is a transfer within a group of companies

Targeted anti-avoidance rule

- Applies where a main purpose is obtaining a tax advantage from the transitional rules and is not a business or other commercial purpose
- HMRC may make an adjustment negating the effect but are not required to do so
- Applies specifically, but not exclusively, to matters affecting the total transitional difference
- Advance clearance procedure available

Rule not intended to catch normal tax planning for 2012

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.