Institute
and Faculty
of Actuaries

IFoA response to Corporate Capital Loss Restriction: Consultation on Delivery

25 January 2019

About the Institute and Faculty of Actuaries

The Institute and Faculty of Actuaries (IFoA) is a royal chartered, not-for-profit, professional body. We represent and regulate over 32,000 actuaries worldwide, and oversee their education at all stages of qualification and development throughout their careers.

We strive to act in the public interest by speaking out on issues where actuaries have the expertise to provide analysis and insight on public policy issues. To fulfil the requirements of our Charter, the IFoA maintains a Public Affairs function, which represents the views of the profession to Government, policymakers, regulators and other stakeholders, in order to shape public policy.

Actuarial science is founded on mathematical and statistical techniques used in insurance, pension fund management and investment. Actuaries provide commercial, financial and prudential advice on the management of assets and liabilities, particularly over the long term, and this long term view is reflected in our approach to analysing policy developments. A rigorous examination system, programme of continuous professional development and a professional code of conduct supports high standards and reflects the significant role of the profession in society.

Institute
and Faculty
of Actuaries

Capital Loss Reform
Room 3/64
CT Capital Losses
BAI
HM Revenue & Customs
100 Parliament Street
London SW1A 2BQ

25 January 2019

Dear Sir/ Madam,

IFoA response to Corporate Capital Loss Restriction: Consultation on Delivery

1. The Institute and Faculty of Actuaries (IFoA) welcomes the opportunity to respond to HMRC's Corporate Capital Losses consultation. Members of our Life Insurance Taxation working party have provided input to this response. Members of the working party have experience of life insurance tax from both insurance firm and wider consultancy backgrounds. However, it is important to note that we have considered HMRC's proposals here from a public interest perspective.

2. We have limited our comments below to HMRC's proposals in Chapter 5 of the consultation; i.e. 'Proposals for life assurance companies'.

3. Having considered carefully the policy objectives set out in Chapter 5, we do not, on balance, believe it is appropriate to apply the 50% rule to the offset of BLAGAB capital losses against BLAGAB capital gains. Our reasoning is set out below:

Reasoning

4. We believe the proposals may have an impact on policyholders, which is not in line with the stated objectives of the change. Whilst some firms may charge policyholders on a stand-alone individual unit-linked or with-profit fund basis, others may credit policyholders if losses in one fund are utilised against gains on another. Similarly, the way in which tax is allocated in with-profit funds can differ substantially between firms.

5. In addition, the 'I minus E' system has two objectives – effectively to collect policyholder tax, but also to ensure that firms pay corporation tax on trading profits. The way in which the system meets these two objectives contains a number of steps, which lead to the production of a shareholders' share and a policyholders' share of 'I minus E' profit. We believe that making changes which impact on the inside workings of that system are likely to cause the system to work less effectively, especially in stress situations. An equivalent may be seen in the case of the 50% rule as applicable to BLAGAB trading losses, where applying the 50% to the inner workings of the 'I minus E' regime led to inappropriate outcomes and which required extremely complicated legislation to address. As explained further in this response, we think the same would be true here.

London 7th Floor · Holborn Gate · 326-330 High Holborn · London · WC1V 7PP · **Tel:** +44 (0) 20 7632 2100 · **Fax:** +44 (0) 20 7632 2111
Edinburgh Level 2 · Exchange Crescent · 7 Conference Square · Edinburgh · EH3 8RA · **Tel:** +44 (0) 131 240 1300 · **Fax:** +44 (0) 131 240 1313
Oxford 1st Floor · Park Central · 40/41 Park End Street · Oxford · OX1 1JD · **Tel:** +44 (0) 1865 268 200 · **Fax:** +44 (0) 1865 268 211
Beijing 6/F · Tower 2 · Prosper Centre · 5 Guanghua Road · Chaoyang District · Beijing China 100020 · **Tel:** +86 (10) 8573 1000 · **Fax:** +86 (10) 8573 1100
Hong Kong 2202 Tower Two · Lippo Centre · 89 Queensway · Hong Kong · **Tel:** +11 (0) 852 2147 9418 · **Fax:** +11 (0) 852 2147 2497
www.actuaries.org.uk

6. Furthermore, the shareholders' share calculation contains some blunt elements within the formula. These may be adequate for the current purposes for which it is used, but we do not believe they are appropriate for limiting the offset of BLAGAB capital losses against BLAGAB capital gains. Again as explained below, the use of this formula is likely to give rise to inappropriate outcomes.

7. A further point is that the 'I minus E' assessment is difficult to forecast, because it is market-driven and can differ significantly from period to period. This means that it would be very difficult to forecast the likely restriction on losses, making it potentially impossible to determine whether the capital losses at the balance sheet date should be valued. This is likely to give rise to accounting and reporting problems. The difficulty arises because the restriction technically applies to the future gains rather than to the losses incurred, and therefore to calculate the restriction it is necessary to model the future gains and determine whether they are likely to be in relation to the shareholder or policyholder.

8. Finally, it is likely that the Solvency II tax position would be extremely difficult to determine, unless there were some 'carve out' for shock losses as there is for the restriction on trade losses. Not only might it be difficult to model the effect of losses in stress, it is possible that the 50% restriction being placed on capital losses might skew the scenarios which would be chosen for the 1 in 200 event, because of the adverse tax outcomes experienced in those scenarios. Capital losses (both realised and unrealised) are more likely to arise in the stress conditions assumed in the Solvency II Solvency Capital Requirement calculations.

Illustration

9. To explain further why we think that there could be inappropriate and difficult to predict outcomes - which might require complicated legislation - we can consider a simplified example.

10. The shareholders' share formula has:

    - BLAGAB Trade Profit (BTP) on the numerator;
    - the denominator has:
        - the first three steps of 'I minus E' (being 'I' and 'G' including capital gains less allowable losses, but not E);
        - plus BLAGAB dividends, but not including a loan relationship deficit which is greater than can be offset against the 'I +G' element.

11. In the case of a firm with significant 'XSI' and a much smaller BLAGAB trade profit, the impact may be quite minor (especially if capital losses are not significant). The shareholders' share formula uses a fraction, the numerator being BLAGAB trade profit, and the denominator being BLAGAB I + capital gains (less losses) + BLAGAB dividends. A decision would have to be made as to how to deal with capital gains and losses in the denominator if there were a capital loss restriction.

12. However, in the case of a market crash, the firm may become 'XSE' (as a result of loan relationship deficits) and have large capital losses. The firm may still have a BLAGAB profit - especially in the case of unit-linked and with-profit business, where the profit is derived from an annual management charge or a bonus declaration, so would not turn into a loss simply because of a market downturn. In this case, the minimum profit test is also likely to be applied. There could be a very high or even 100% restriction on capital losses in this scenario, creating complicated iterations with the minimum profit test/shareholders' share calculations, because the application of the restriction would itself increase the 'I minus E' profit. There is already

significant technical difficulty in determining how the shareholders' share of capital gains calculation works if capital losses are offset from outside the BLAGAB calculation, if the minimum profit test applies in the same period. However, this is a much less common calculation than the normal offset of BLAGAB capital losses against capital gains.

13. The same firm in either case (XSI or XSE) would have no restriction at all if there were a BLAGAB trade loss, even if this were only £1. The impact is potentially volatile due to the nature of the 'I minus E' calculation, and this could lead to potential unfairness to with profit policyholders.

14. One of the principal issues identified above is that the largest restrictions on capital losses are likely to arise in stress, even though the capital losses being restricted in those circumstances are likely to be predominantly in relation to the policyholder. This is because the capital losses are likely to be higher, but also that the minimum profit test/XSE scenarios are more likely to apply.

15. The effect of the above is to increase the allocation of gains and losses to shareholders in stress conditions (where losses are more likely), whereas in benign conditions the allocation of gains is likely to be smaller because the shareholders' share is likely to be smaller, and losses are less likely. Hence there would be a bias towards the effective allocation of losses to shareholders, making it more difficult to obtain relief.

16. It is possible that there may be alternative ways of determining the restriction other than using the shareholders' share formula. However we are concerned that any approach may introduce further complexity into the 'I minus E' regime.

Should you want to discuss any of the points raised please contact me via Steven.Graham@actuaries.org.uk or on 020 7632 2146 in the first instance.

Yours sincerely,

Steven Graham
Technical Policy Manager
On behalf of President, Institute and Faculty of Actuaries