

The impact of FRS16 on reported profits

Actuarial Profession Life Office Taxation Working Party

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‘A new accounting standard reduces published pre tax profits’

This is not the sort of headline that directors dream of reading at their morning breakfast table. Such news is particularly unwelcome if there are no good business reasons for the problem. However, a modest new accounting standard could have precisely this effect.

The problem affects pre tax profits reported on a statutory, modified statutory or an embedded value basis and is caused by a new accounting standard called FRS16 (Financial Reporting Standard 16). This new standard applies to all accounts prepared in respect of any company year ending after 23 March 2000.

This article considers some of the background to calculating pre tax embedded value profits and reviews the possible impact of this new standard on the tax rate assumed for grossing up profits. Please note that this article deals only with concepts and does not identify any of the detailed issues that inevitably apply in real tax calculations.

Grossing up profits

Many companies report profits on an embedded value basis. These profits are normally calculated net of tax and results have to be ‘grossed up’ using assumed tax rates to obtain pre tax profits.

Standard actuarial practice calculates embedded values net of policyholder tax and deducts shareholder tax at the ‘marginal’ tax rate. This marginal tax rate is normally around 10% for life business profits and the corporation tax rate (30% from April 1999) or slightly less for pensions business profits. The key issues relate to life business profits and so pension business profits are not considered further. (For those of you who are familiar with tax jargon, ‘life business’ refers to the business described in legislation as Basic Life Assurance and General Annuity business or BLAGAB.)

Simplistically we could calculate the pre tax embedded value by reversing the deduction for shareholder tax described above. However, the net embedded value is normally grossed up at the full corporation tax rate. There are three possible reasons for using the higher tax rate. Firstly and cynically, the resulting pre tax profits may be higher than by using the alternative. The second reason could be that 30% is the current rate of corporation tax, which is the rate of tax at which shareholders would expect their profits to be taxed. The third and key reason is that it is (almost) theoretically justified.

To illustrate the justification, consider profits arising in just one year on life assurance business. A classical actuarial viewpoint would be as follows:

- Life business is taxed on income less expenses (I-E profit) at policyholder tax rates that are currently either 20% or 22%.

- Additional tax is payable on a notional amount of shareholder profit (NC1 profits), which is considered to be part of the I-E profit, in order to raise the tax rate to corporation tax rates on these profits. This additional tax is the marginal tax referred to above.
- Since future NC1 profits are effectively the profits valued in an embedded value calculation, the value of future net shareholder profits needs to allow for this additional tax as well as the standard I-E tax.

Hence there is a sound basis for the standard actuarial approach to calculating net embedded values.

However, an ‘alternative view’ is set out in the Inland Revenue's Life Assurance Manual. This shows the I-E profit to be divisible between policyholders and shareholders as set out in Example 1.

Example 1 – Proof that I-E is equal to all the taxable profits in the life business fund

Premiums	P
Investment income & gains	I
Expenses	E
Claims (including increases in reserves)	C
Shareholders’ profit (SP) can be expressed as	$P + I - E - C$
or	$I - E - (C - P)$
The policyholders’ return from policies (PP) is the difference between claims proceeds and premiums paid,	
so	$PP = C - P$
so	$SP = I - E - (PP)$
so	$I - E = SP + PP$
QED	

From this example we can see that shareholders obtain their profits by deducting pre tax investment income from policyholders. This implies that net shareholder profits are equal to the total pre tax income deducted from policyholders less tax at corporation tax rates. Hence shareholders' pre tax profits are equal to their post tax profits grossed up at corporation tax rates.

Does this view apply in all circumstances? Consider the embedded value of a simplified unit linked bond. All investment income is allocated to policyholder units. Shareholders' profit is equal to the annual management charge. An actuary might argue that the charge is neither income nor expense and so is not taxed in the I-E calculation although the charge does increase NC1 profit. Surely this profit is only taxed at the shareholder marginal rate!

This ‘actuarial view’ would obtain the correct answer but it has not correctly identified the source of the profit. Example 2 reconciles this ‘actuarial view’ with the ‘alternative view’.

Example 2 - Taxation of an annual management charge on a unit linked bond

Assume a £10,000 unit linked bond in the life business fund receives fully taxable income of 10% at the end of a year, pays an annual management charge of 1% at the end of the same year and that there are no expenses or other revenues.

	Classical actuarial view	Alternative view
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Opening linked fund	£10,000.00	£10,000.00
Income (10%)	£1,000.00	£1,000.00
Less income deducted*		£(125.00)
Net income	£1,000.00	£875.00
Tax charged on policyholder income at 20%	£(200.00)	£(175.00)
Annual Management charge (1%)	£(100.00)	
Closing policyholder fund	£10,700.00	£10,700.00
Shareholder profit / income	£100.00	£125.00
Shareholder tax – Marginal tax rate (12.5% **)	£(12.50)	
Corporation tax rate (30%)		£(37.50)
Net shareholder profit	£87.50	£87.50

* The income deducted equals the £100 annual management charge grossed up at the policyholders tax rate of 20%.

** It can be shown that the marginal rate of shareholder tax would be 12.5% $(=(30\%-20\%)(100\%-20\%))$ in this example.

Example 2 shows that the ‘alternative view’ would consider an annual management charge of 1% to be a deduction from income of 1.25% which would then be taxed at full corporation tax rates.

In this example, the shareholders marginal tax rate is 12.5% but a lower rate normally applies when some of the income arises from UK equity dividends. Since the corporation tax rate applied to UK equity dividends is now 0%, no marginal shareholder tax arises on this income and so the marginal tax rate is normally an average of 0% and 12.5%.

Impact of the new FRS16

This brings us to the change to accounting standards that require UK equity dividends to be reported net in both the Companies Act accounts and the statutory returns to HM Treasury.

Until the July 1997 budget, UK equity dividends were paid net of tax but included reclaimable tax credits. The budget (or rather the Finance Act (No. 2) 1997) stopped most tax credit reclaims and the value of the tax credit changed to 10% from April 1999. However, companies continued to report the dividends showing gross income (including tax credits at 20% or 10% from April 1999) but with a tax charge that included the unrecovered tax credits. This justified reporting gross shareholder profits including the value of tax credits.

However, FRS16 says: ‘Incoming dividends should be recognised as the amount received or receivable without any attributable tax credit’. (Paragraph 9)

This effectively treats UK equity dividends as non taxable income and the concept of tax credits becomes obsolete. Although this proposed standard is written specifically for reporting in annual Companies Act accounts, guidelines will require the same standards to be applied to HM Treasury returns.

Is this appropriate? Surely the dividend has been taxed at source (the ‘net’ dividend is paid out of taxed profits) and so tax already paid could be imputed into the account of the life assurance company. However, previous practice only imputed the value of tax credits at an assumed a tax rate of 20% rather than the full corporation tax rate ultimately paid by companies on their profits. Hence pre tax life assurance profits have not reflected ‘true’ gross profits for some time and this change simply removes all credit for tax paid at the source of the dividends.

Pre tax embedded value profits

The principles for calculating pre tax profit in one year should readily extend to embedded value profits. Embedded value profits are normally the difference between the values of two profit streams calculated at the start and end of the year, plus the profit emerging during the year, all net of tax. Tax implicit in the embedded value profits calculation could be:

- the implicit tax allowed for in the closing embedded value; less
- the implicit tax allowed for in the opening embedded value; plus
- the actual tax in the current year statutory profit.

However there are likely to be differences between the bases and assumptions used in the calculation of the opening and closing embedded values and the result of this calculation may not give a coherent figure for the tax that should be associated with the embedded value profit.

The ABI's statement of recommended practice (SORP) on Accounting for Insurance Business recognises these difficulties and recommends that net of tax embedded value profits should be 'grossed up' to provide pre tax profits. The grossing up should be at the 'effective rate' of tax but could be at the 'full rate of corporation tax' unless this produces a 'material misstatement'.

A suitable 'effective tax rate' could be the average shareholder tax rate implicit in the closing embedded value calculation. This would be a weighted average of the rate of tax on UK dividend income and the full rate of corporation tax. However the tax rate for UK dividends would need to be 0% to be consistent with the presentation in the Companies Act accounts.

Hence unless the proportion of shareholder UK dividend income is a small proportion of shareholder profits, using a grossing up tax rate of 30% may materially miss-state the pre tax profit result.

The ABI recommendation has an interesting consequence that may lead to a miss-statement regardless of the tax rates used. If part of the change in embedded value arises due to a change in the shareholder tax assumptions then the post tax embedded value profit may reflect this assumption change. This element of the profit would then be grossed up when calculating the pre tax embedded value profit. However, the pre tax embedded value profit should not be affected by changes to shareholder tax assumptions and so there is clearly a miss-statement of the pre tax result. This is particularly pertinent in view of the reductions to corporation tax rates that have occurred in the last few years.

Summary

FRS16 proposals may have a sufficient impact on average tax rates to force life assurance companies to reduce their assumed tax rates for grossing up embedded value profits. However, the impact on individual companies will depend on the materiality limits that are applied to their reported results.

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