



The Actuarial Profession

making financial sense of the future

Life Office Taxation Seminar



Disclaimer

The information contained herein is of a general nature and is not intended to address the circumstances of any particular individual or entity. Although we endeavour to provide accurate and timely information, there can be no guarantee that such information is accurate as of the date it is received or that it will continue to be accurate in the future. No one should act on such information without appropriate professional advice after a thorough examination of the particular situation.



The Actuarial Profession

making financial sense of the future

Introduction



Gavin Coates

Programme

09.00-09.30	Registration and refreshments
09.30-09.40	Chairman's welcome Gavin Coates
09.40-10.15	Life Office Tax overview Steve Jones
10.15-11.00	The 'I-E' Calculation Choi-Ling Li
11.00-11.15	Morning refreshments
11.15-11.45	Apportionment James Latta
11.45-12.35	Case study parts 1 and 2: 'I-E' computation
12.35-12.40	Review of case study parts 1 & 2
12.40-13.30	Lunch

13.30 –14.20	'Shareholders' tax & Gross roll-up business taxation Choi-Ling Li
14.20-15.20	Case study parts 3 and 4: Trading profits taxation
15.20-15.30	Review of case study parts 3 & 4
15.30-15.45	Afternoon refreshments
15.45-16.20	Tax modelling and planning Trevor Fanning
16.20-16.50	Current developments Mike Allen
16.50– 17.15	Conclusion and questions
17.15	Close



The Actuarial Profession

making financial sense of the future

Life Office Tax Overview



Steve Jones

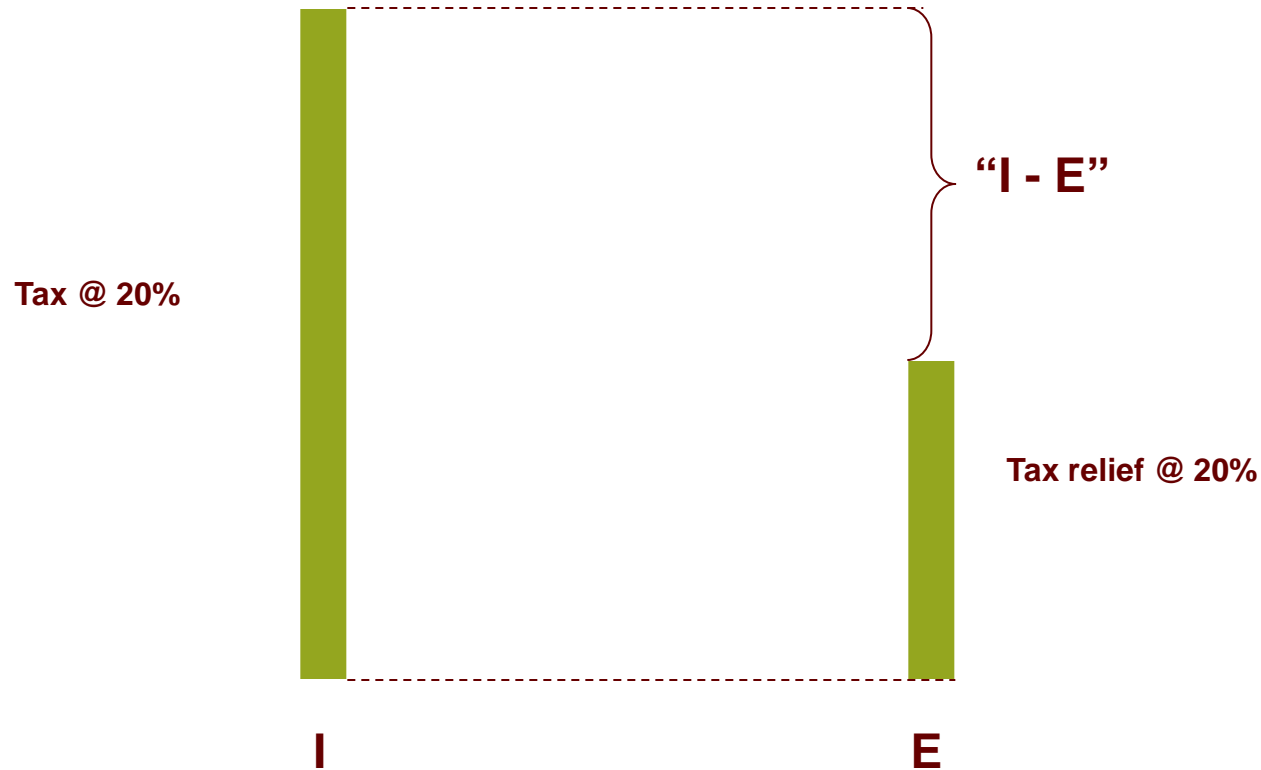
Introduction

- Why worry about tax?
- A simplistic tax model
- What tax formula should I use in my profit-testing model?
- A case study
- Some complications
- Some practical investigations

Why worry about tax?

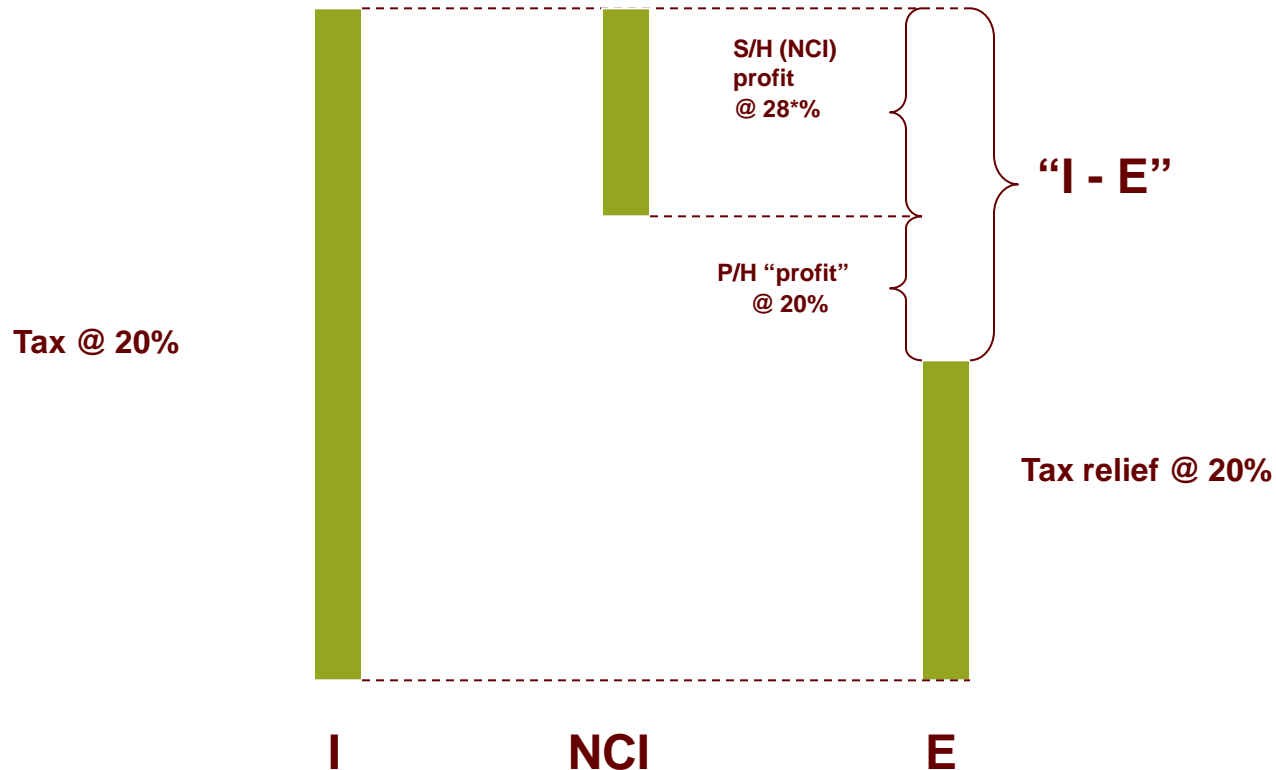
- Tax returns for HMRC (Her Majesty's Revenue & Customs)
- Product design
- Profit reporting (UK statutory, EV, IFRS, ...)
- Project appraisals
- One of the few areas (outside product pricing) where the difference between a good and a bad job is worth £ms

Simplistic tax model: Mutual



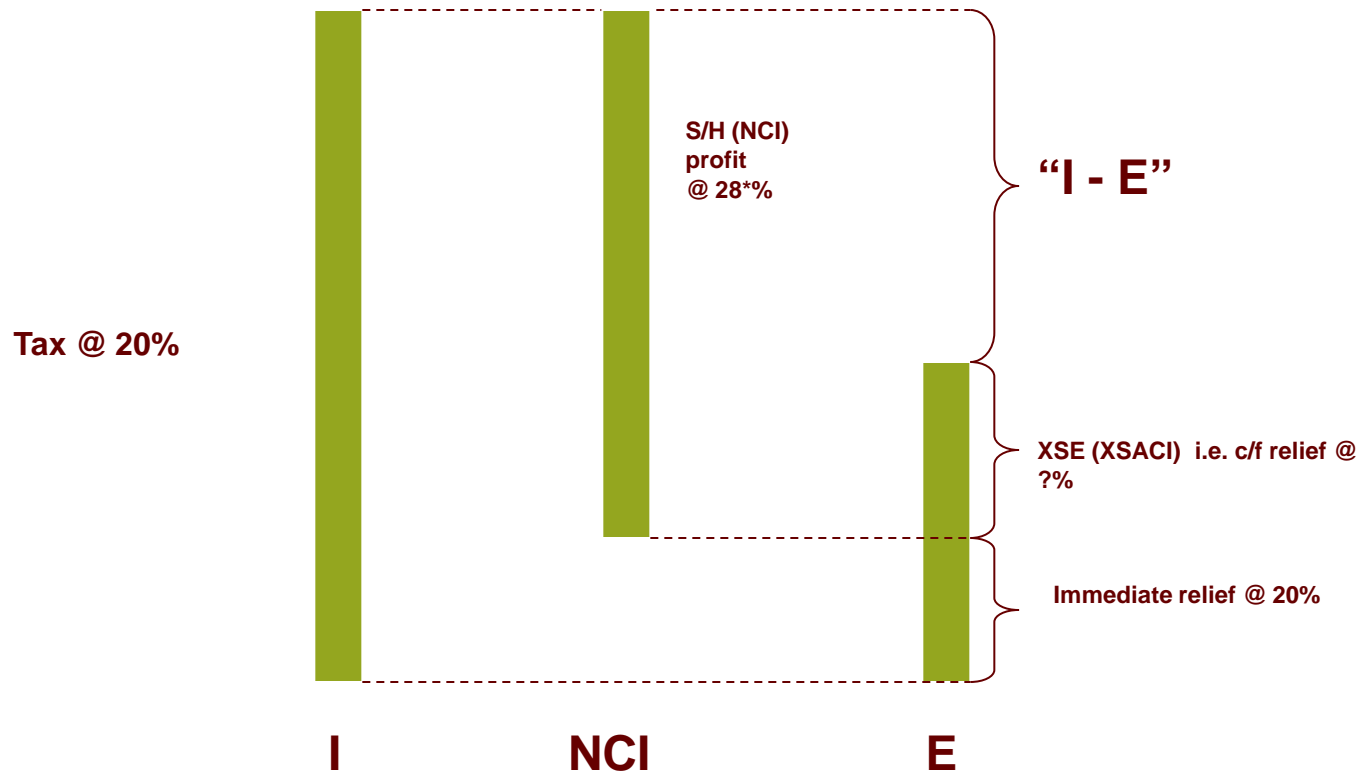
Pre-tax profit earned by Life Office =	+ Premiums	+ Investment Returns	- Expenses	- Claims	(+ timing)
Pre-tax profit earned policyholders =	- Premiums			+ Claims	(- timing)
<hr/>					
Aggregate pre-tax profit to tax =		+ Investment Returns	- Expenses		

Simplistic tax model: Proprietary Net (or Excess I) situation



*: The tax rate is changing over the next few years ... 28% is the rate up to March 2011 (with 2011 / 2012 / 2013 / 2014 rates expected to be 26% / 25% / 24% / 23%)

Simplistic tax model: Proprietary Gross (or Excess E) situation



What tax formula should I use in my profit-testing model?

- Most reserving / profit-testing models (Prophet, Moses, ...) make a reasonable but simplistic tax assumption
 - E.g. 28*% profits for Pensions business written in a proprietary company
- Is this correct?

A case study

- Proprietary life office selling Life protection business
- New business creates lots of Expenses (E) and some Profit (NCI), but little Investment Income (I)
- Individual business line profit-testing model tells us
 - claims are around 55% of premiums
 - expenses + commission (E) are around 40% of premiums
 - cost of capital is around 5% of premiums
 - tax relief is around $20\% \times 40\% (E) = 8\%$ of premiums
 - net profit is around 8% of premiums
- But what happens in practice is different ...

Case study: protection business only

	Protection	Investment	Global adj.	Total
Pre-tax profit	0	0	0	0
I - E	(40)	0	40	0 (+ 40 XSACI c/fwd)
P/h tax (on I-E)	8	0	(8)	0
S/h tax (on NCI)	0	0	0	0
Post-tax profit	8	0	(8)	0

Case study: protection + easy-to-sell investment business

	Protection	Investment	Global adj.	Total
Pre-tax profit	0	10	0	10
I - E	(40)	50	0	10 (+ 0 XSACI c/fwd)
P/h tax (on I-E)	8	(9)	(0.8)	(1.8)
S/h tax (on NCI)	0	(1)	0	(1)
Post-tax profit	8	0	(0.8)	7.2

When office is Excess I: $\text{tax} = 20\% \times (I - E) + (28\% - 20\%) / (1 - 20\%) \times \max(0, \text{pre-tax profit} - 20\% (I - E))$

My “Policyholder tax” line is the (I - E) component of this calculation - taxed at 18*% when pre-tax profit exceeds 20% (I - E) - and my “Shareholder tax” line is the pre-tax profit component - taxed at 10*% in that situation

Case study: protection + “too much” easy-to-sell investment business

	Protection	Investment	Global adj.	Total
Pre-tax profit	0	20	0	20
I - E	(40)	100	0	60 (+ 0 XSACI c/fwd)
P/h tax (on I-E)	8	(18)	(0.8)	(10.8)
S/h tax (on NCI)	0	(2)	0	(2)
Post-tax profit	8	0	(0.8)	7.2

Case study: protection + hard-to-sell investment business

	Protection	Investment	Global adj.	Total
Pre-tax profit	0	5	0	5
I - E	(40)	45	0	5 (+ 0 XSACI c/fwd)
P/h tax (on I-E)	8	(8.5)	(0.4)	(0.9)
S/h tax (on NCI)	0	(0.5)	0	(0.5)
Post-tax profit	8	(4)	(0.4)	3.6

Case study: protection + “too much” hard-to-sell investment business

	Protection	Investment	Global adj.	Total
Pre-tax profit	0	10	0	10
I - E	(40)	90	0	50 (+ 0 XSACI c/fwd)
P/h tax (on I-E)	8	(17)	0	(9)
S/h tax (on NCI)	0	(1)	0	(1)
Post-tax profit	8	(8)	0	0

Case study: conclusions

- The tax rules can put protection-only companies at a competitive disadvantage as no credit is given for XSACI (formerly known as XSE)
- To get value from the XSACI, it is necessary to write some extra business for which $(I - E) - NCI > 0$
- But this extra business needs to be profitable
- And if the extra business is only profitable while the company has unused XSACI, you need to carefully monitor the volume sold

Complications: I

- Most investment returns flow immediately into I
- ... but equity gains only appear when realised (and you get indexation relief then)
- CGT reserves on indexed unrealised equity gains (unit prices, asset share calculations)
- E.g. unit price = $(MV - 20\% \times IUCG \times v^{-t}) / \text{Number of units}$
- Should we give credit for losses?

Complications: E & NCI

- Not always allowed to count deferred E or XSACI for valuation purposes
- Valuation should be cautious if usage isn't certain:
 - For traditional EV, possibly write down asset value to allow for probability asset won't be used as quickly / at all
 - After a 1-in-200 1-year ICA stress test, it may take a long time / forever to use all the losses

A practical investigation

Simple expected tax bill ($18\% \times (I - E) + 10\% \times \text{NCI} + 28\% \times$
“Case VI”) (100)

Good new business volumes this year ... deferred E increases and
will be used in future years rather than this (20)

Good new business volumes this year ... XSACI created and will
be used in future years rather than this (10)

New business strain creates NCI losses this year with no
immediate relief received (10)

Apportionment rules quirks mean 95% rather than 100% of
investment returns appear in the tax calculations 7

Some Case VI losses from prior years used in this year's tax
computation 6

Tax bill calculated by business plan tax model (127)

Summary

- Why worry about tax?
- A simplistic tax model
- What tax formula should I use in my profit-testing model?
- A case study
- Some complications
- Some practical investigations



The Actuarial Profession

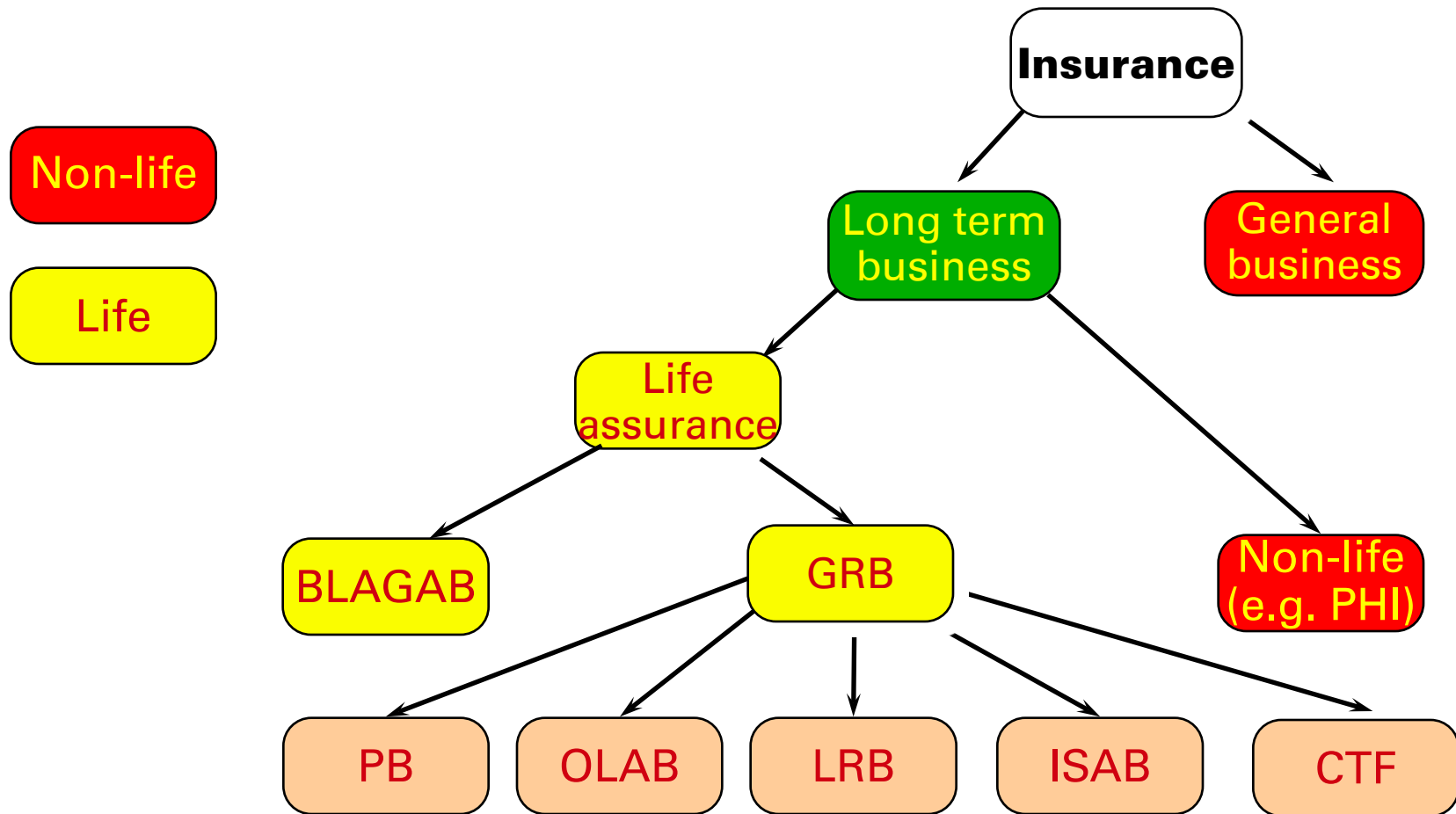
making financial sense of the future

The “I-E” Calculation



Choi-Ling Li

Categories of Insurance Business



Definitions

“the I minus E basis” (s431(2) ICTA1988) revision in Finance Act 07

“means the basis under which a company carrying on life assurance business is charged to tax on the relevant profits (s88(3) FA1989) of that business otherwise than under section 35 of CTA 2009 (charge on trade profits)”

Basic Life Assurance and General Annuity Business (“BLAGAB”) - (s431F ICTA 1988) revision in FA 07

“Life assurance business other than gross roll-up business”

Objective of I – E Calculation

To tax the:

- proprietary office on the shareholder's share of the profit (at corporation tax rate)
- policyholder on their share of the profit (at the savings rate)

“Proof” of I-E scope

	Shareholders' return £
Premiums	2000
Claims	(1500)
Investment return	1000
Expenses	(500)
Opening liabilities	9500
Closing liabilities	(10200)
Bonuses	(270)
Surplus	30
Return to policyholders	
I - E	

“Proof” of I-E scope

	Shareholders' return £	Policyholders' return £
Premiums	2000	(2000)
Claims	(1500)	1500
Investment return	1000	
Expenses	(500)	
Opening liabilities	9500	(9500)
Closing liabilities	(10200)	10200
Bonuses	(270)	270
Surplus	30	
Return to policyholders		470
I - E		

“Proof” of I-E scope

	Shareholders' return £	Policyholders' return £	Total
Premiums	2000	(2000)	
Claims	(1500)	1500	
Investment return	1000		1000
Expenses	(500)		(500)
Opening liabilities	9500	(9500)	
Closing liabilities	(10200)	10200	
Bonuses	(270)	270	
Surplus	30		
Return to policyholders		470	
I - E			500

Example I minus E computation

	£	£
<i>BLAGAB Investment Income</i>		
Property income (net of expenses)		x
<i>Non-trading income – loan relationships</i>		
Income from loan relationships	x	
Capital movements on loan relationships	x	
Interest Payable	<u>(x)</u>	
		x
Non-trading income (other)		x
Miscellaneous income (foreign dividends)		x
Corporation tax on income (formerly Sch D case VI)		<u>x</u>
		x
<i>BLAGAB Chargeable gains</i>		<u>x</u>
Total BLAGAB income and chargeable gains		x
<i>Gross Roll up (PB/ISAB/OLAB/LRB/CTFB) business profit</i>		x
Less: <i>expenses of management</i>		(x)
capital allowances		<u>(x)</u>
Taxable I minus E result		<u>x</u>

BLAGAB Investment Income

Old schedule	CTA 09	Description
Schedule A	Property income	Rental income i.e. income from UK land and Real Estate Investment Trusts ('REIT') distributions
Schedule D Case III	Non-trading income	Profits & gains from loan relationships (gilts and bonds)
Schedule D Case V	Miscellaneous income/ Trading income	Income arising from overseas assets

Example I minus E computation

	£	£
<i>BLAGAB Investment Income</i>		
Property income (net of expenses)		x
<i>Non-trading income – loan relationships</i>		
Income from loan relationships	x	
Capital movements on loan relationships	x	
Interest Payable	<u>(x)</u>	
		x
Non-trading income (other)		x
Miscellaneous income (foreign dividends)		x
Corporation tax on income (formerly Sch D case VI)		<u>x</u>
		x
<i>BLAGAB Chargeable gains</i>		<u>x</u>
Total BLAGAB income and chargeable gains		x
<i>Gross Roll up (PB/ISAB/OLAB/LRB/CTFB) business profit</i>		x
Less: expenses of management		(x)
capital allowances		<u>(x)</u>
Taxable I minus E result		<u>x</u>

BLAGAB sundry income

Corporation tax on income

	£
Life reinsurance deemed income	X
Section 85 Finance Act 1989 income	
<i>e.g. Underwriting commission</i>	X
<i>Stock lending fees</i>	<u>X</u>
Corporation tax on income	X

Example I minus E computation

	£	£
<i>BLAGAB Investment Income</i>		
Property income (net of expenses)		x
<i>Non-trading income– loan relationships</i>		
Income from loan relationships	x	
Capital movements on loan relationships	x	
Interest Payable	<u>(x)</u>	
		x
Non-trading income (other)		x
Miscellaneous income (foreign dividends)		x
Corporation tax on income (formerly Sch D case VI)		<u>x</u>
		x
BLAGAB Chargeable gains		<u>x</u>
Total BLAGAB income and chargeable gains		x
<i>Gross Roll up (PB/ISAB/OLAB/LRB/CTFB) business profit</i>		x
Less: expenses of management		(x)
capital allowances		<u>(x)</u>
Taxable I minus E result		<u>x</u>

BLAGAB chargeable gains

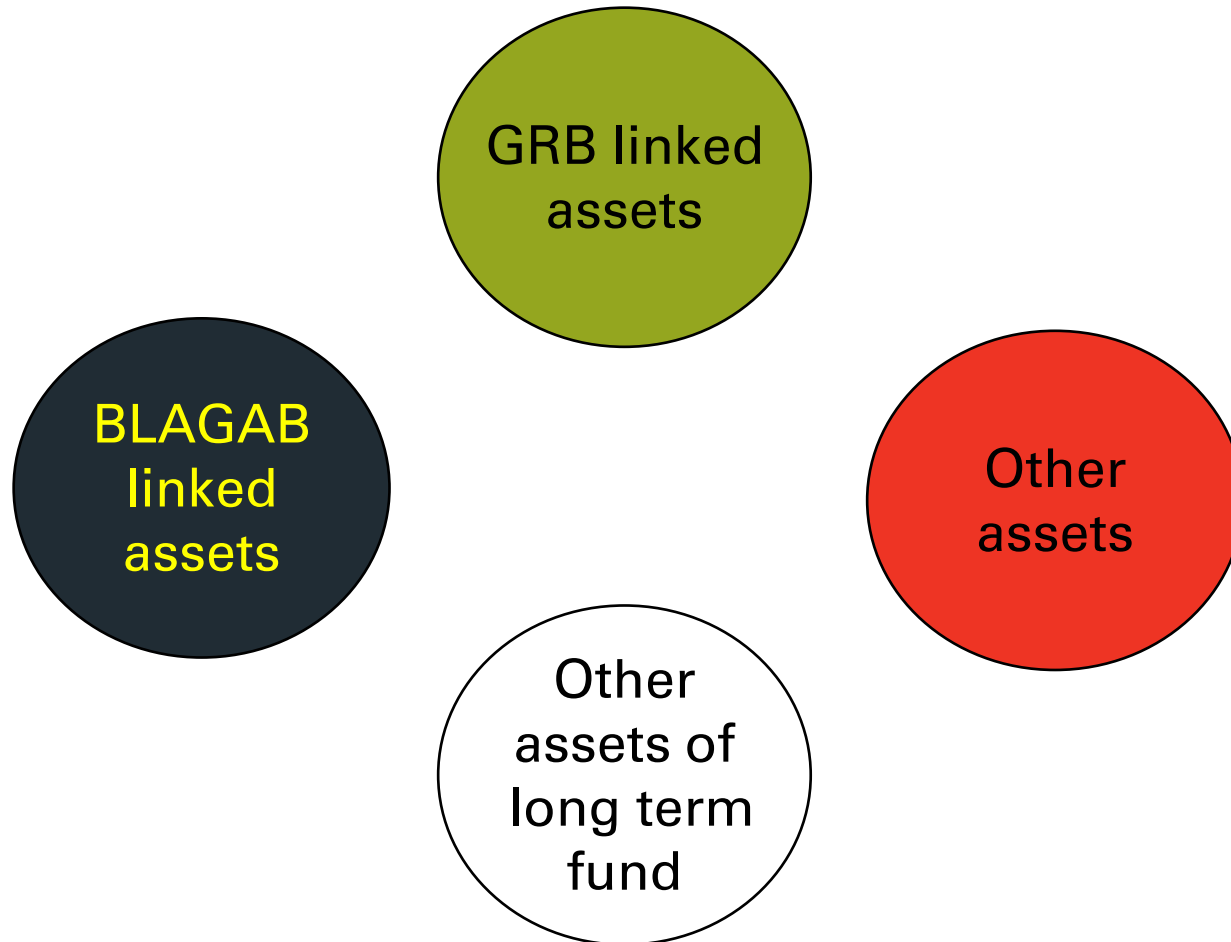
Chargeable gains on disposals of investments	X
Section 212 TCGA 1992 gains on deemed disposals of Unit Trusts, OEICs and interests in offshore funds	X
Less allowable losses brought forward	(X)
	—
	X
	—

Annual deemed disposal of UTs / OEICs

Sections 212 and 213 TCGA 1992 say:

- Where an insurance company holds units in authorised unit trusts (or relevant interests in an offshore fund) in its long term fund, there is a deemed disposal and reacquisition of those units or interests at market value at the end of the accounting period
- Rules only apply to gains or losses which are either directly referable or apportioned to BLAGAB
- Gains arising are spread forward over 7 years
- Losses can be carried back for 2 years against deemed disposal gains

Chargeable gains 'boxes' (s440 ICTA)



Example I minus E computation

	£	£
<i>BLAGAB Investment Income</i>		
Property income (net of expenses)		x
<i>Non-trading income – loan relationships</i>		
Income from loan relationships	x	
Capital movements on loan relationships	x	
Interest Payable	<u>(x)</u>	
		x
Non-trading income (other)		x
Miscellaneous income (foreign dividends)		x
Corporation tax on income (formerly Sch D case VI)		<u>x</u>
		x
BLAGAB Chargeable gains		<u>x</u>
Total BLAGAB income and chargeable gains		x
<i>Gross Roll up (PB/ISAB/OLAB/LRB/CTFB) business profit</i>		x
<i>Less: expenses of management</i>		(x)
capital allowances		<u>(x)</u>
Taxable I minus E result		<u><u>x</u></u>

Expenses of Management (s76 ICTA)

- Expenses must be attributable to BLAGAB in accordance with 'proper accounting practice'
- Expenses must be brought into account on lines 12, 22 or 25 of Form 40 in order to be deductible
- Expenses cannot exceed the taxable BLAGAB income and gains in the tax computation.

Acquisition expenses (s86 FA89)

Such of the following as are attributable to the company's BLAGAB business:

- commissions
- other expenses of management which are disbursed **solely** for the purpose of the acquisition of business, and
- appropriate part of other expenses of management disbursed partly for acquisition of business

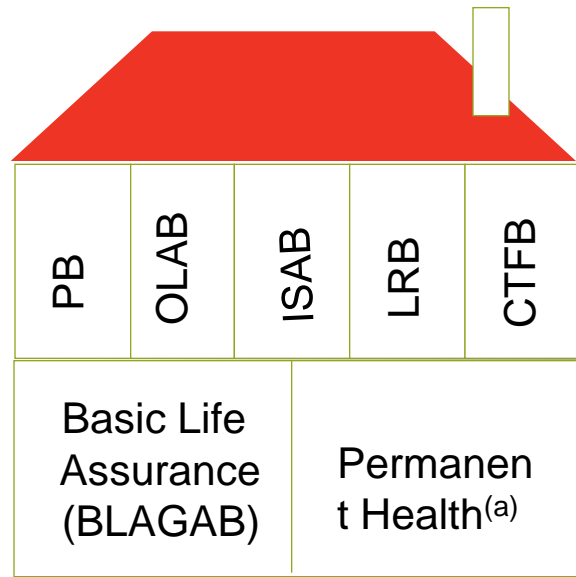
Spreading of acquisition expenses

- Aim is to match acquisition expenses incurred with the long-term nature of the policy
- Expenses related to acquisition and renewal of business are spread over seven years
- Applies to any such BLAGAB expenses disbursed during the period

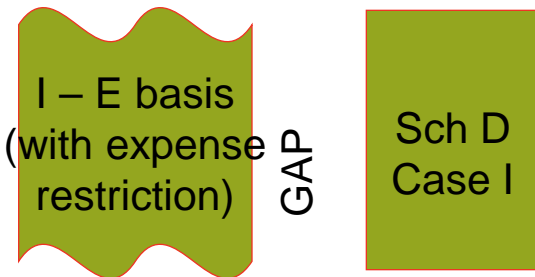
Spreading of acquisition expenses

[illegible]

The Life Assurance Tax House (pre FA07)



Foundations



Lots of rooms

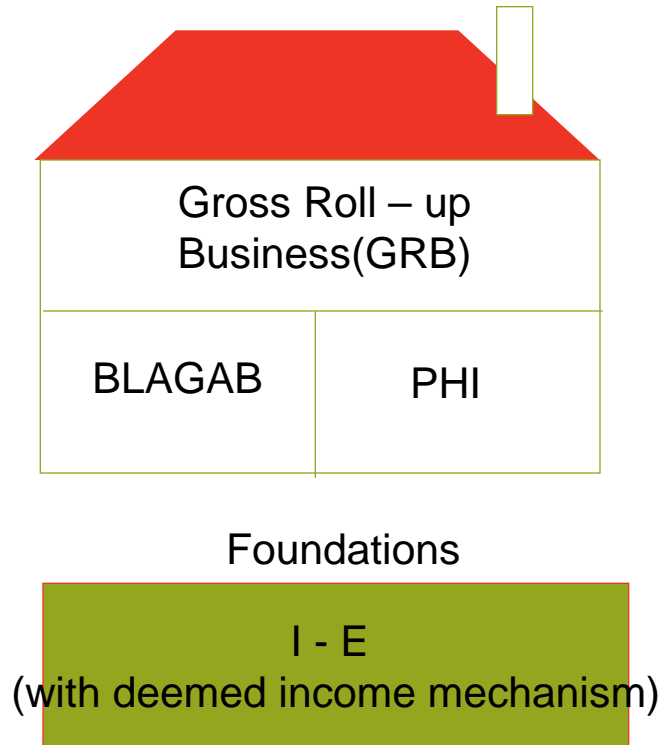
- Lots of rooms/categories hence complex appointments
- Very limited offset of losses limited

Foundations old and unstable

- 2 bases of taxation
- Actual Case I very rarely applied
- I – E basis usual but its limitations gives opportunity for tax free income in specific circumstances
- 2 bases not mutually complimentary
- Carried forward losses probably lost on transition

(a) Permanent health insurance business is taxed on a trading profit basis separately from the other insurance business shown

The Life Assurance Tax House (post FA07)



- But segregation of old pension losses remains
- Abolition of the deemed overseas life assurance fund
- Deemed income used to force
- I – E result to at least equal the notional life assurance trade profit (formerly NCI) result less BLAGLAB UK dividends
- Proper definition of “I - E basis” for first time

(a) Permanent health insurance business is taxed on a trading income basis separately from the other insurance business shown

The Actuarial Profession

making financial sense of the future

Morning refreshments



The Actuarial Profession

making financial sense of the future

Apportionment

James Latto

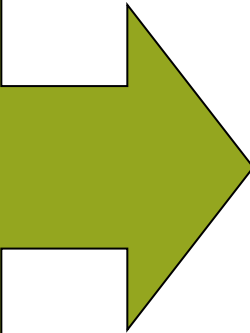
Allocation of Investment Income & Gains

- **Why is apportionment necessary?**
 - to allocate income and gains across the classes of long term business



How does apportionment work?

At a high level the calculation of the tax payable follows a three step process:



Step 1: Calculate the investment return

Step 2: Divide the return between BLAGAB and GRU

Step 3: Apply the appropriate tax rates

In practice there are caveats and complications at each step

Example of Step 1: Calculating income & gains for a non-profit office

	UK Dividends	Investment Income	Realised Gains	Unrealised Gains
BLAGAB	Exclude	All	Chargeable	-
GRU	Include	All	All	All
PHI	Exclude	All	All	All



The Actuarial Profession

making financial sense of the future

Application between BLAGAB and GRU

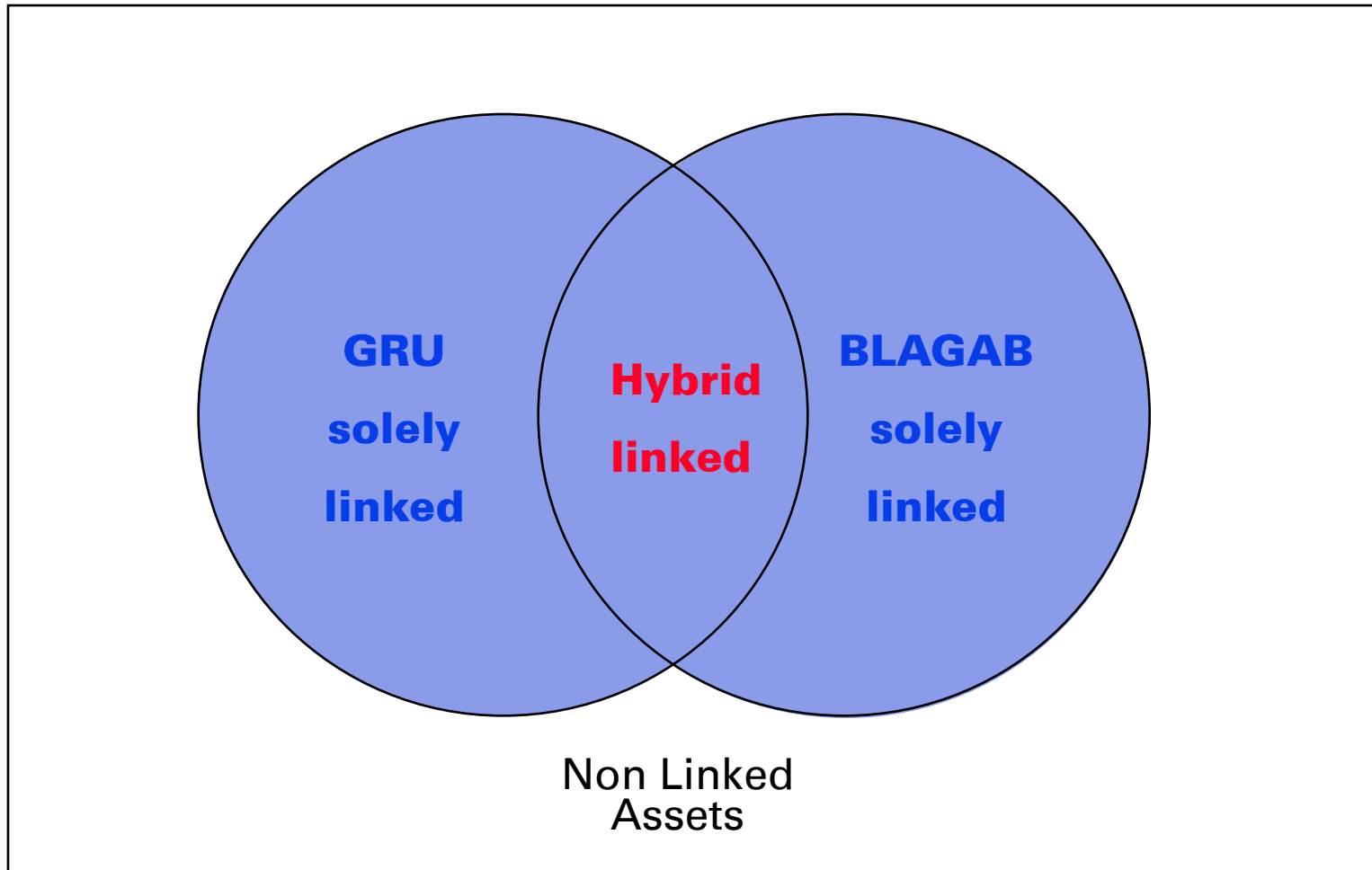


James Latto

Definition of linked assets - s432ZA ICTA 1988

“assets of an insurance company which are identified in its records as assets by reference to the value of which benefits provided for under a policy or contract are to be determined”

Assets of long term fund



Allocation of income and gains

	BLAGAB	GRU
Solely Linked	Actual	Actual
Other assets	Proportion	Proportion
Total	<u>XXX</u>	<u>XXX</u>

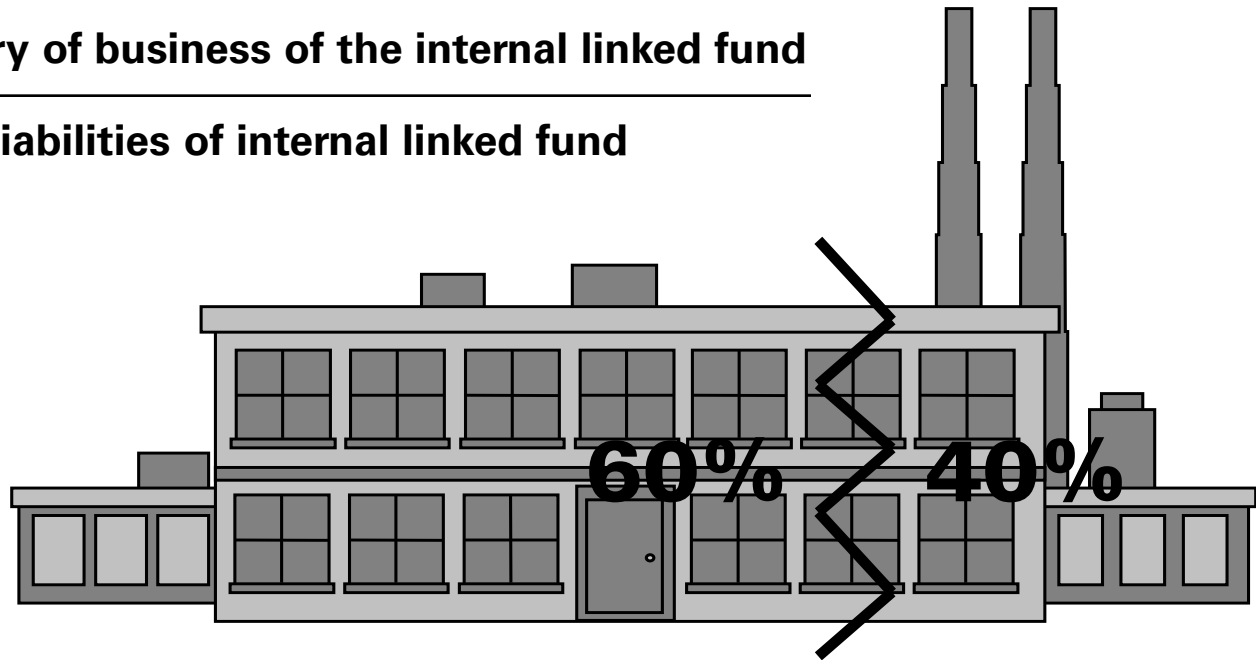
Hybrid Linked Assets

How to allocate

- If proportion of value of asset attributed in FSA return to category of business - use that proportion
- If not use

Liabilities of category of business of the internal linked fund

Total linked liabilities of internal linked fund



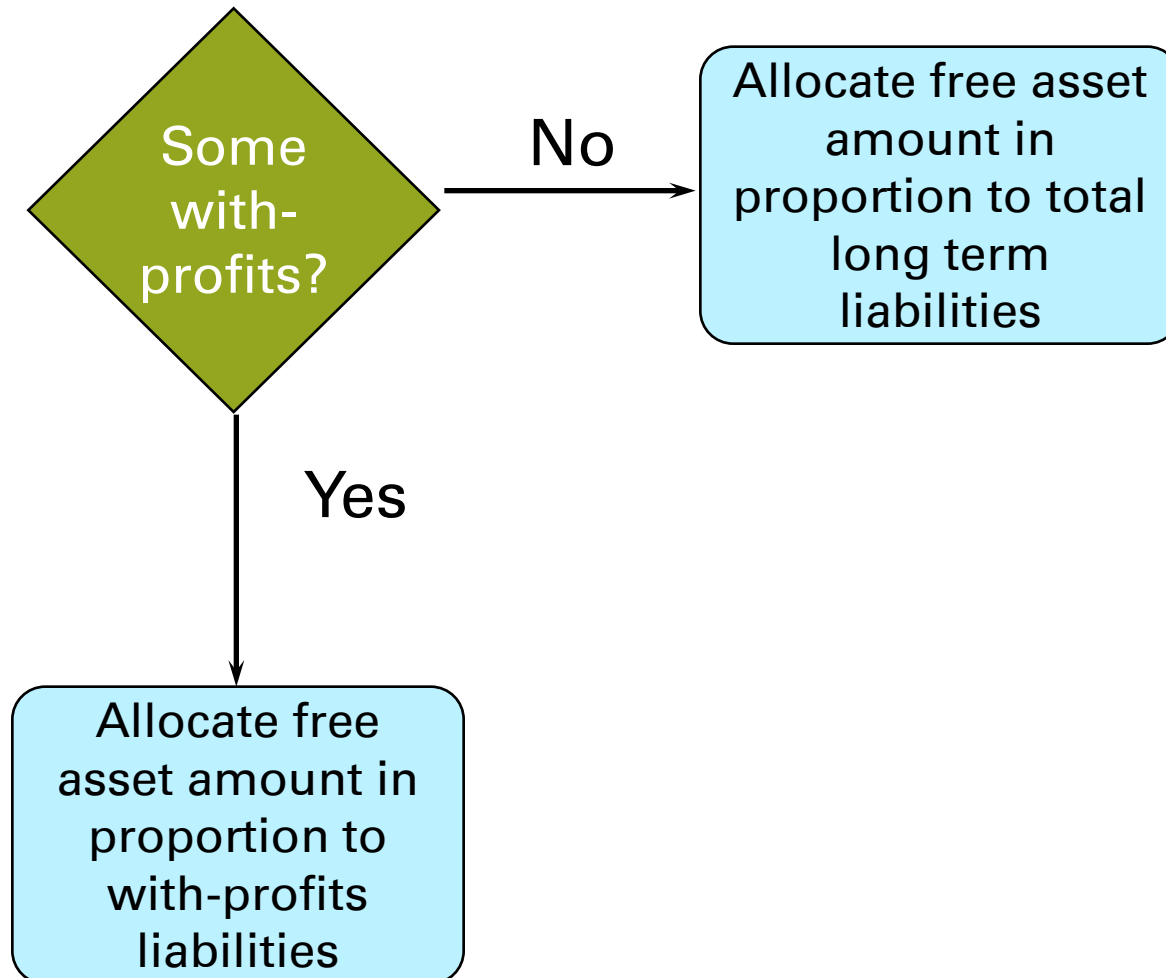
Allocation for BLAGAB purposes

James Latto

Fraction (s432A ICTA 1988)

	BLAGAB	GRU	Total
	£	£	£
Mean liabilities	X	X	X
Less: mean linked assets	(X)	(X)	(X)
add: mean of appropriate part of Free Asset amount	X	X	X
	<u>A</u>	<u>B</u>	<u>C</u>
Percentage	A/C	B/C	100%

What about with profits?



Allocation for GRU computations

James Latto

Investment return principles

Tax legislation follows FSA return and not first principles

“Tax profit” measurement follows FSA surplus

So far as referable to a particular category of business, the following items “brought into account” shall be taken to be receipts of the period:

- all income included in Form 40 (lines 12 & 15)
- any increase in value (whether realized or not) of linked and non-linked assets included in Form 40 (lines 13&14)

With Profit GRU 'Needs' Basis, S432E

- GRU Investment Return is greater of:
 - The amount needed to provide profits to cover bonus payments and shareholder transfer
 - The 'floor'

GRU profit computation

			£
Liability brought forward			X
Premiums			X
Investment return ^(†)			X
			<hr/>
			X
Claims including annuities	X		
less bonuses paid in anticipation	(X)		
		X	
Expenses		X	
Closing liabilities (excl. bonuses)		X	
			(X)
Pre-tax surplus			X
Bonuses declared			(X)
Disallowed expenses			X
Policyholders' overseas tax			(X)
Schedule D GRU profit			X

(†) dividend income included net of tax credits

Fraction (s432 C&D ICTA 1988)

Non-profit business

	BLAGAB £	GRU £	Total £
Mean liabilities	X	X	X
Less mean linked assets	(X)	(X)	(X)
	—	—	—
	<u>A</u>	<u>B</u>	<u>C</u>
Percentage	A/C	B/C	100%

Choosing the right fraction: s432A vs. s432B ICTA 1988

S432B tells us which apportionment fractions we should use for receipts brought into account.

For non-profit GRB we use s432C, for with profit business we use s432E.

	s432A	s432C
Mean O&C liabilities	😊	😊
Less mean O&C linked assets	😊	😊
Mean O&C appropriate part of FAA	😊	

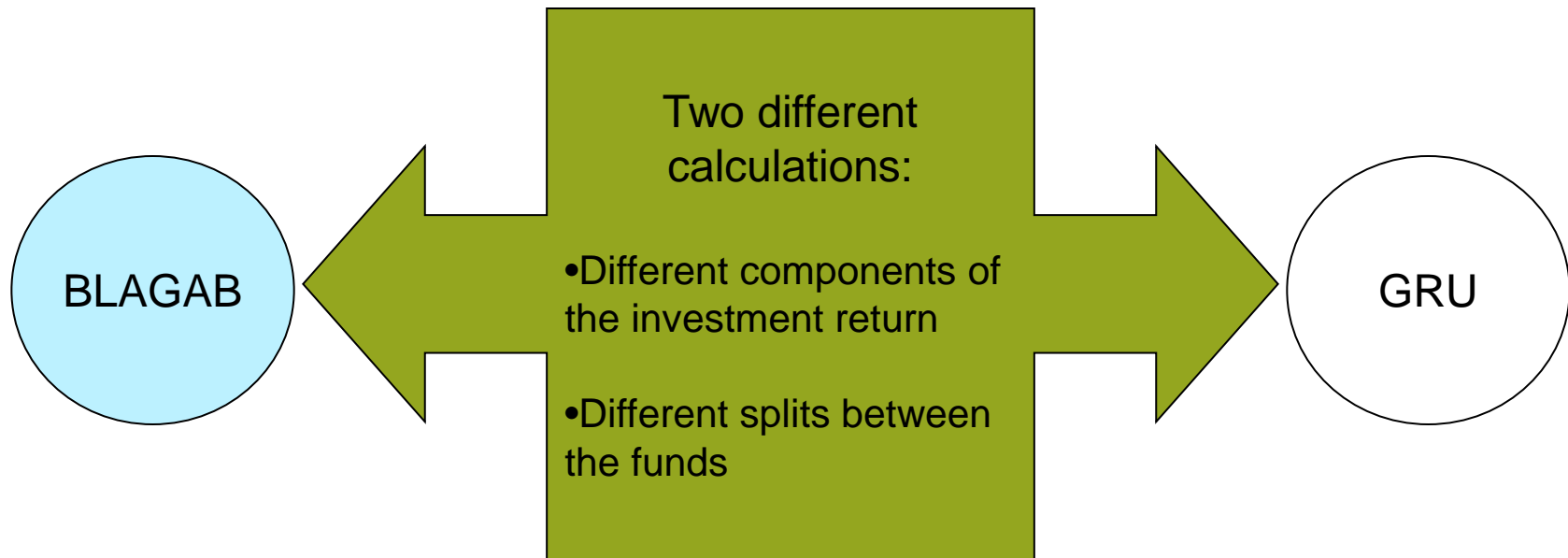
Very similar formula, just ignores Free Asset Amount



Summary and conclusion

James Latto

Putting it all back together



There is no guarantee that the total investment return equals the sum of the parts

Allocation of income and gains

	BLAGAB	GRU
Solely Linked	Actual	Actual
Other assets	Proportion Y	Proportion Z
Total	<div><div>XXX</div></div>	<div><div>XXX</div></div>

Uses of the allocations

	BLAGAB	GRU	PHI
<i>Section 432A allocations ("I-E")</i>			
UK dividends (net)	✓	x	x
UFII	✓	x	✓
Sundry income	✓	x	✓
Chargeable gains	✓	x	✓
Unrealized Gains	x	x	✓
<i>Section 432B allocations ("GRU")</i>			
Investment return	x	✓	x

The Actuarial Profession

making financial sense of the future

Case Study Parts 1 & 2



The Actuarial Profession

making financial sense of the future

Review of Case Study Parts 1 & 2



Shareholders' Tax and Notional Trading Profits

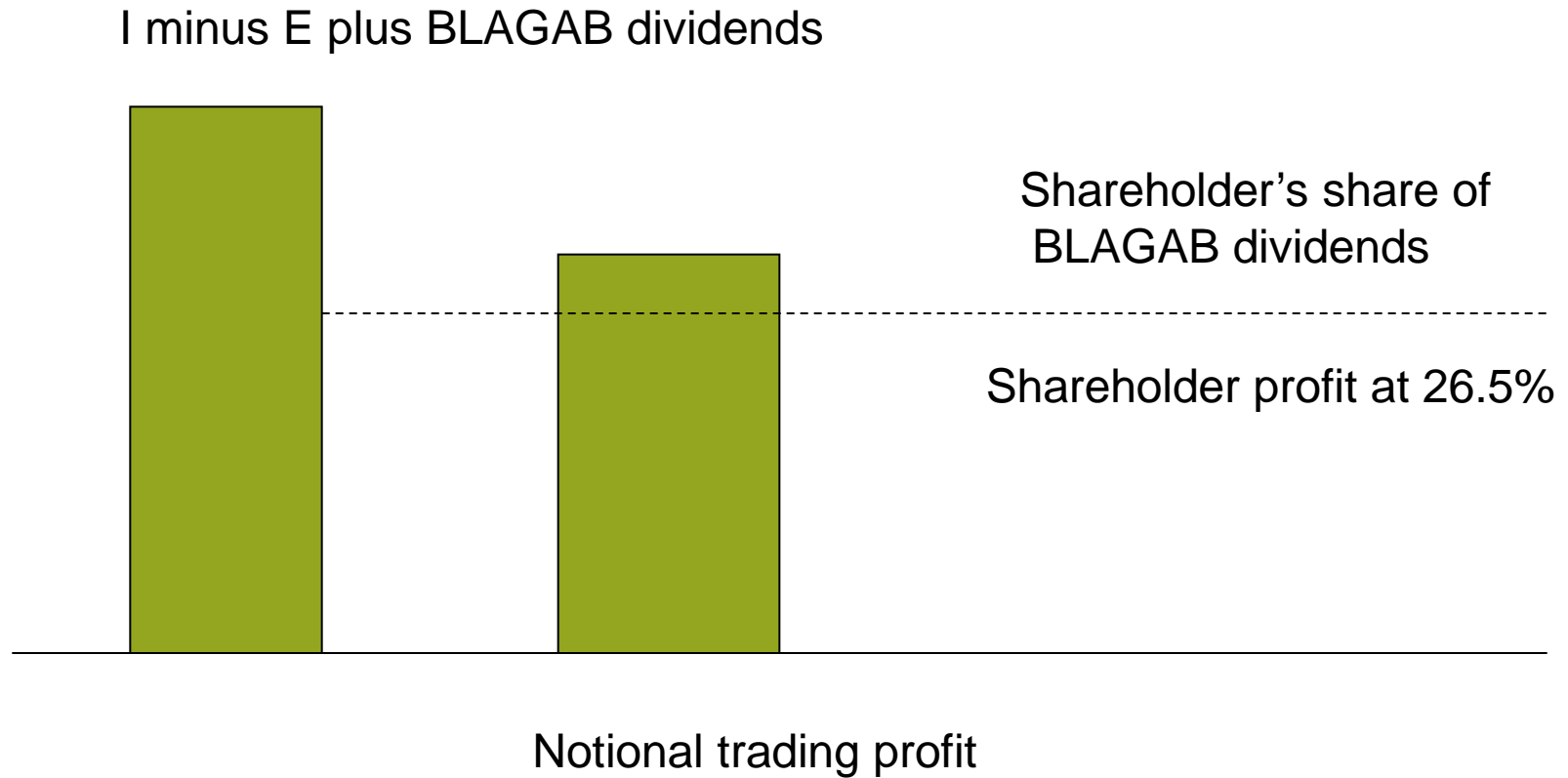
Choi-Ling Li

Why do we need a notional trading profit computation?

The I-E computation aims to tax both the shareholder and policyholder on their relevant share of the profits

- Per HMRC Manual a trading profit (formerly Case I) basis of computation may be needed to calculate:
 - the policyholder's share of the relevant profits
 - Minimum profits test - Notional income rules which replace the notional trading profit restriction of the relief for expenses of management
- Profits are taxable at 26.5% and losses are available for group relief

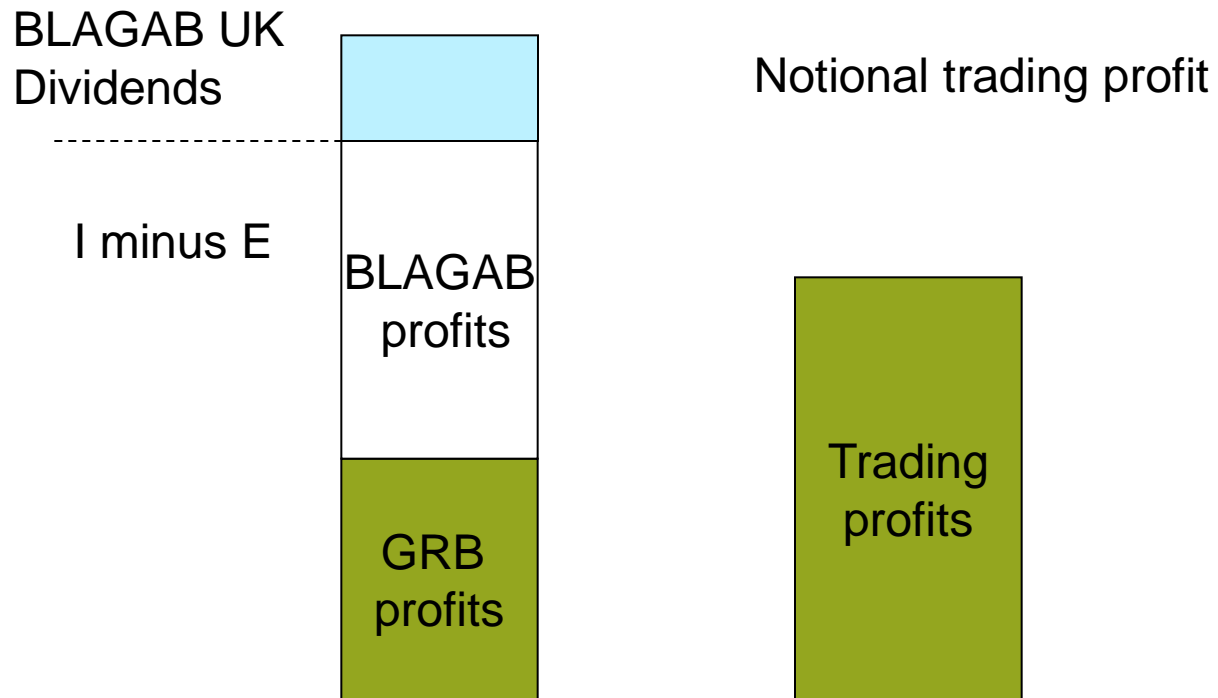
Minimum Profits test



How is the notional trading profit calculated?

	£	£
Surplus arising in the year (Form 58)		X
Less: surplus on non-life business	X	
tax attributable to non-life business	(X)	
		X
Surplus arising on life business		X
Add: disallowed expenses		X
Less: capital allowances	(X)	
bonuses paid and declared	(X)	
		(X)
Net Notional Trading Profit		X
Add: tax provision per Form 40	X	
Less: policyholders' tax	(X)	
Shareholders' tax		X
Gross notional trading profit		X

Ideal world – Step 1



Ideal world – Step 2

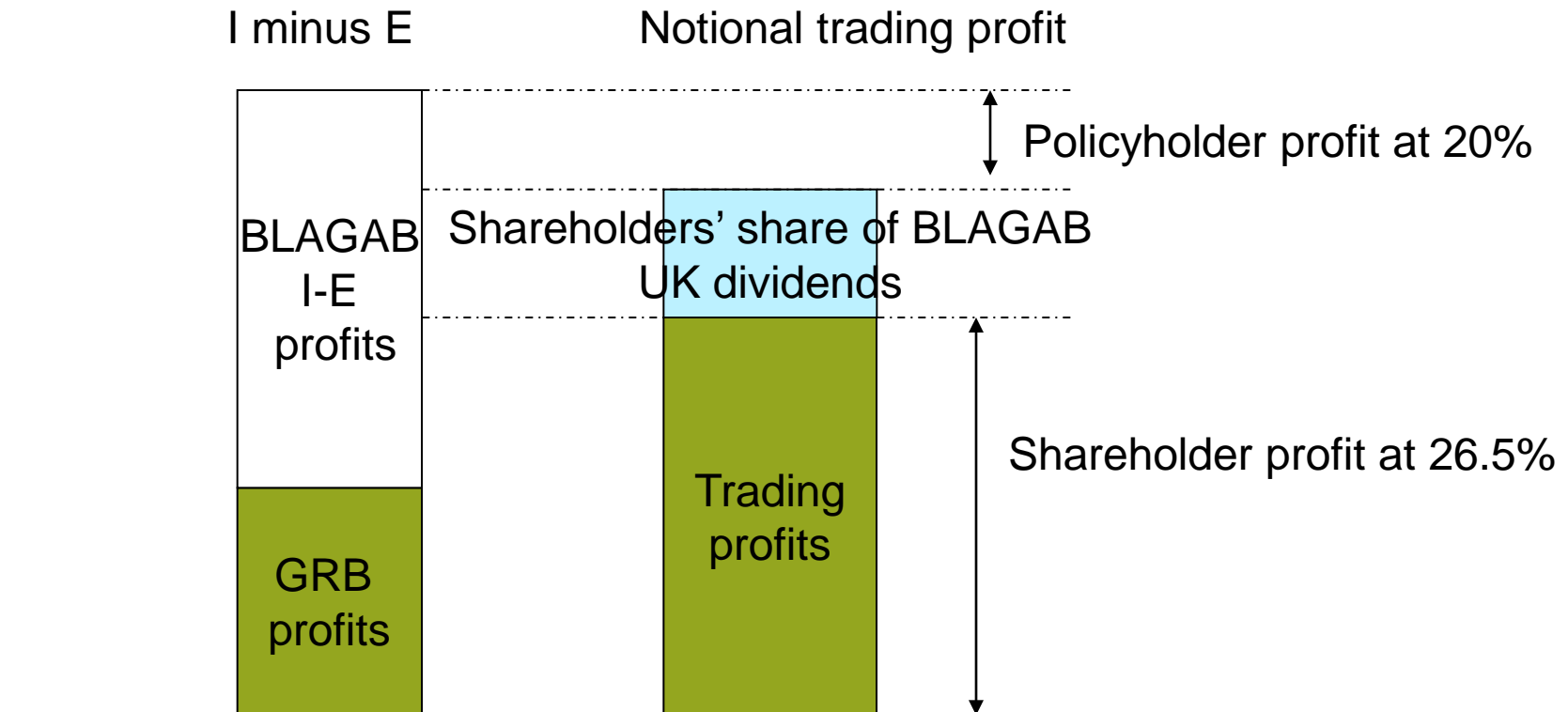


Illustration of old rules

I minus E

Notional trading profits

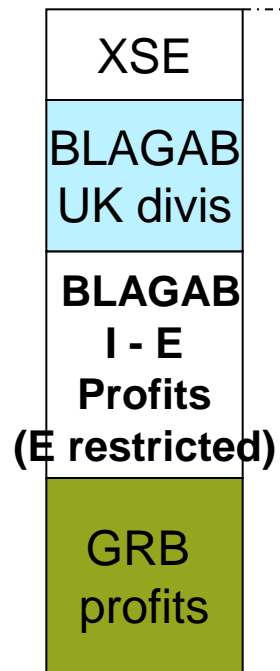
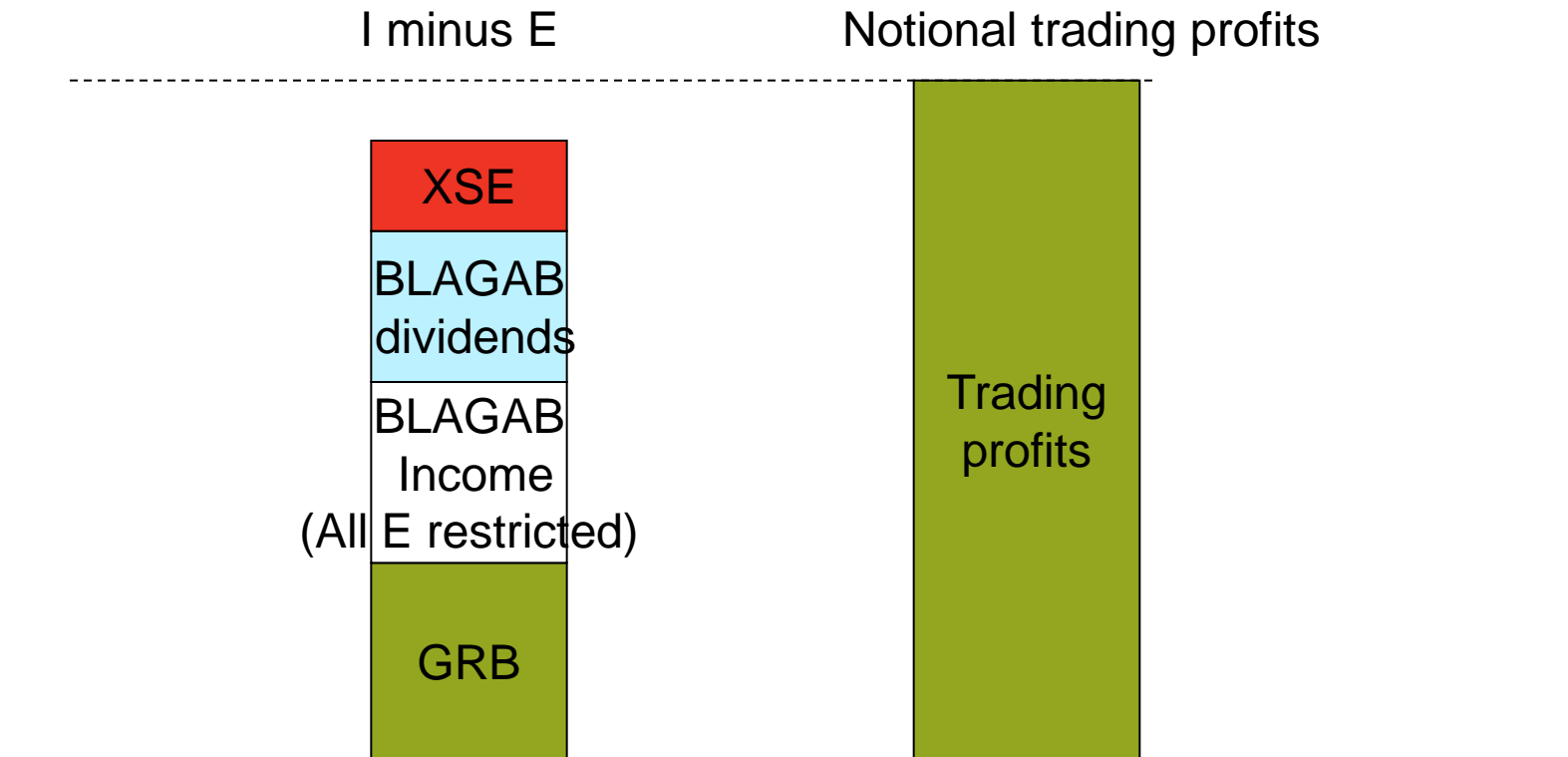


Illustration of old rules



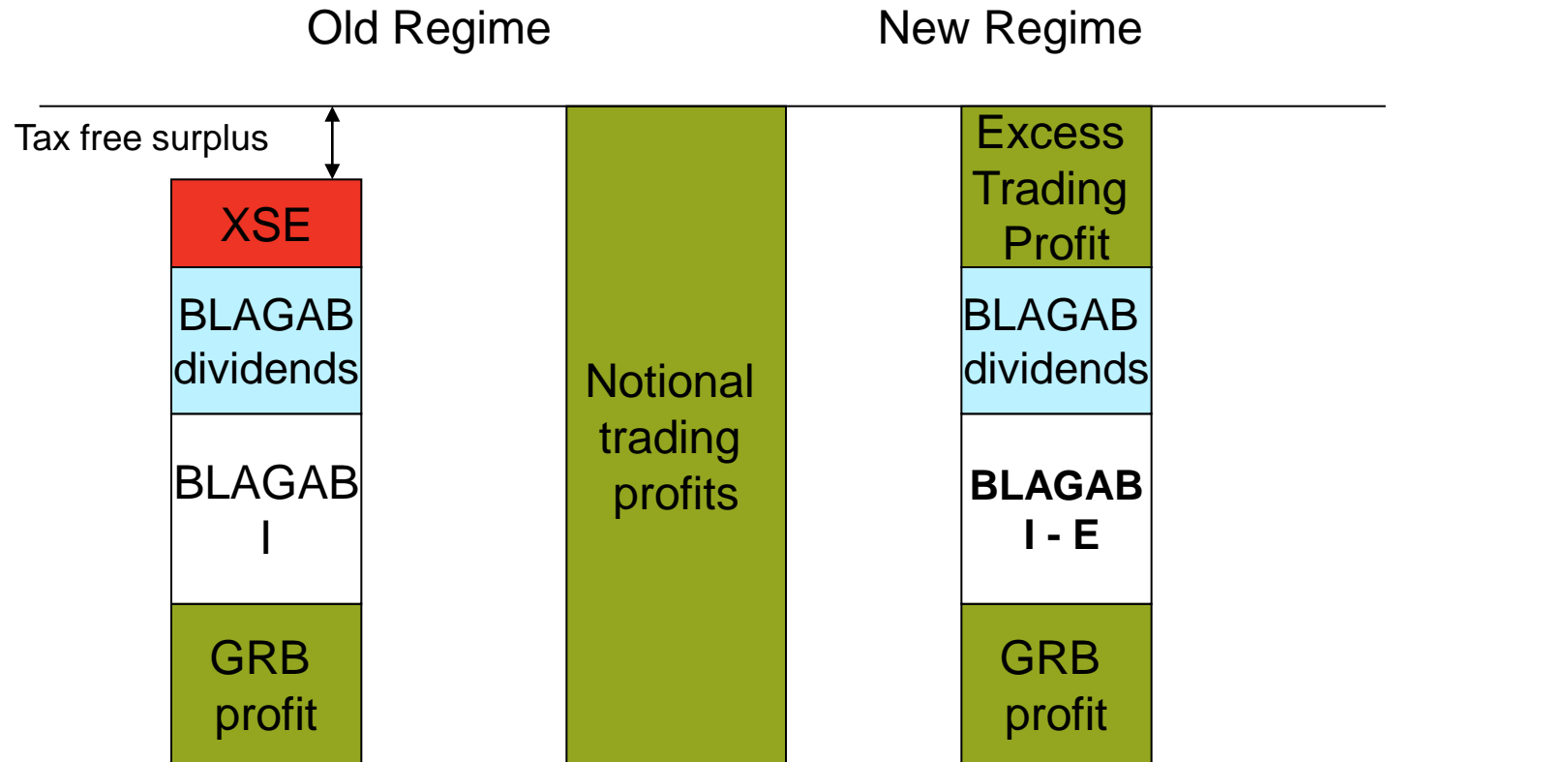
If XSE fully restricted and a 'gap' still existed then there was a potential for HMRC to impose an Actual trading profits assessment. BLAGAB dividends then taxed, XSE lost, s.86 DAE & qualifying (GRB) losses only available if revert back to I minus E.

When was the Actual trading profits (actual case I) enforced?

Per HMRC Manual there were two circumstances the option to tax on an I minus E basis was revoked:

- With notice when
 - substantial surpluses emerge from a closed book of business
 - When company has substantial underwriting profits but little investment income (short term protection business)
 - When company only writes business taxed using trading profits principles
- Temporarily
 - Use an avoidance scheme
 - Large release of surplus to shareholders
 - Significant change in the nature of the business written

Revision to the Crown Option in FA 07



Simple example: Expense restriction

BLAGAB income	100
---------------	-----

BLAGAB expenses	50
-----------------	----

UK Dividends	20
--------------	----

Shareholders share of dividends	50%
---------------------------------	-----

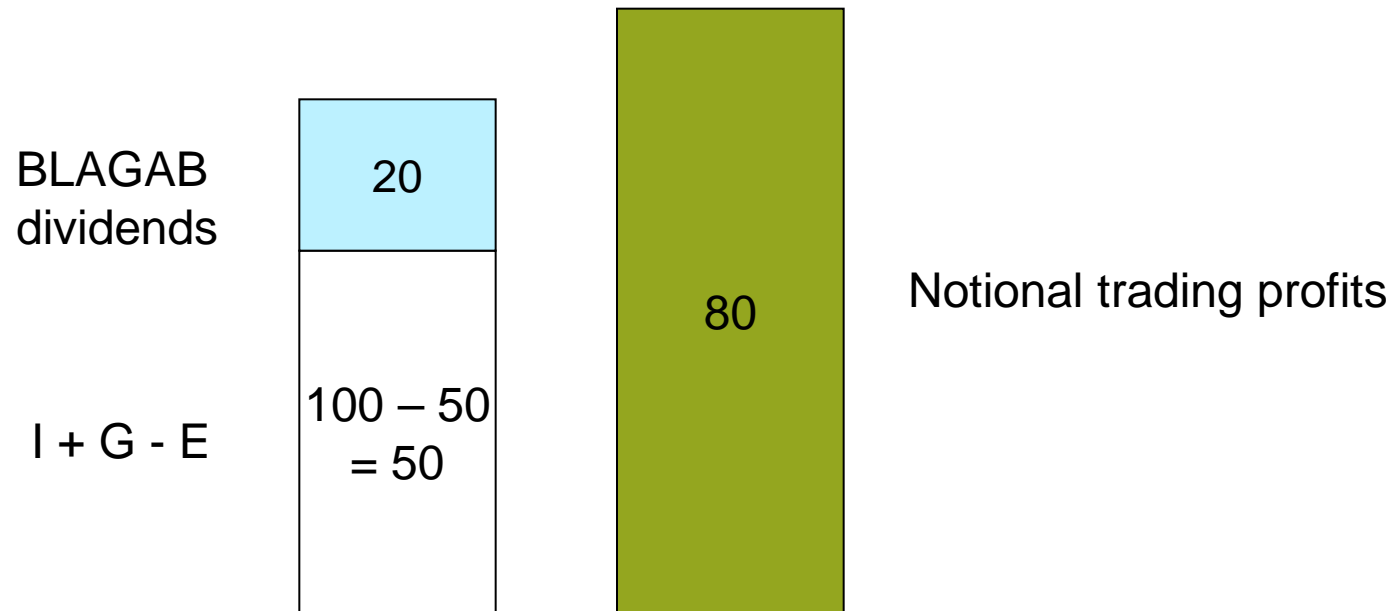
Notional trading profits	80
--------------------------	----

Question 1: What is the expense restriction using old legislation?

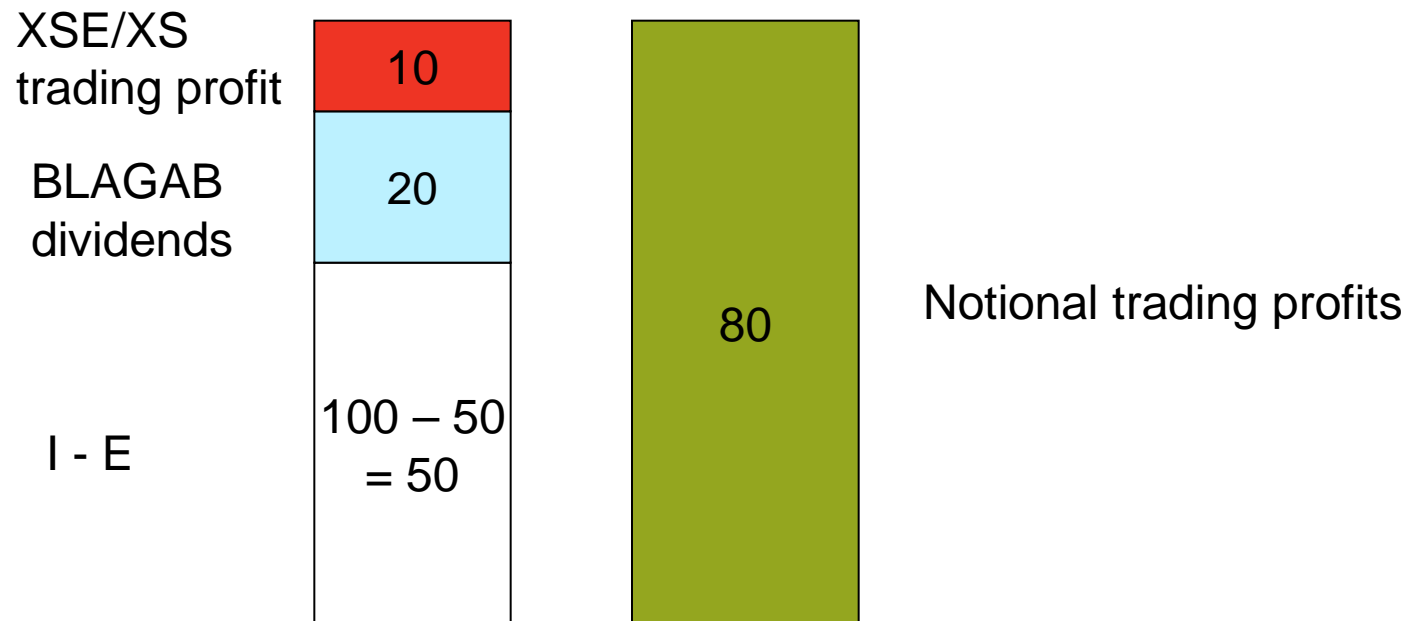
Question 2: What is the XSTP profit carried forward under FA 07?

Question 3: What is the amount of profit chargeable at 26.5%

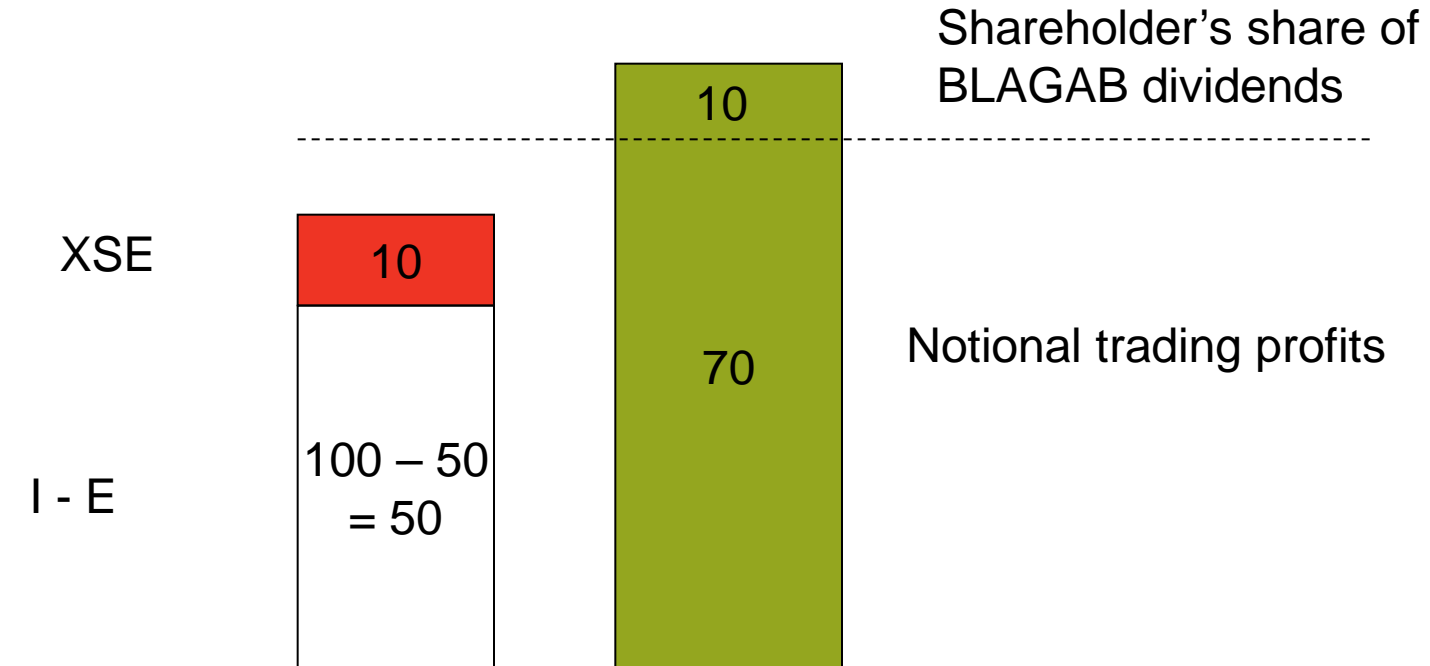
Answer Q1 & Q2



Answer Q1 & Q2



Answer to Q3



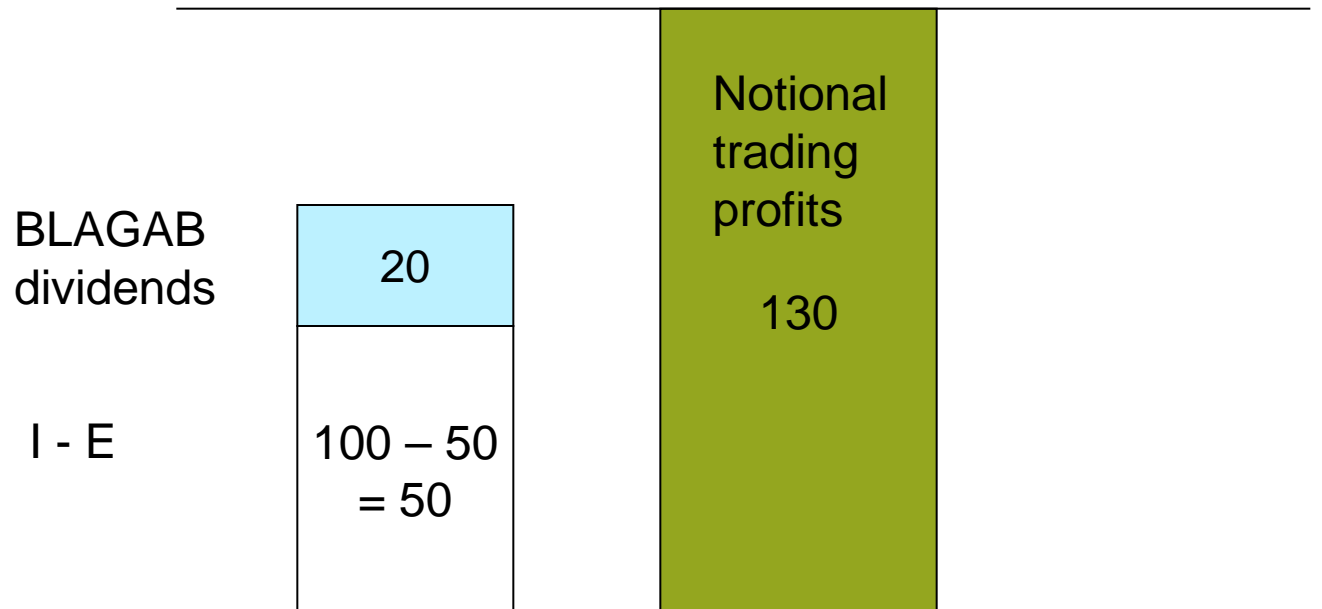
Simple example: Expense restriction (2)

BLAGAB income	100
BLAGAB expenses	50
UK Dividends	20
Shareholder proportion of dividends	20%
Notional trading profits	130

Question 1: What is the expense restriction using old legislation?

Question 2: What is the XS trading profit carried forward under FA 07?

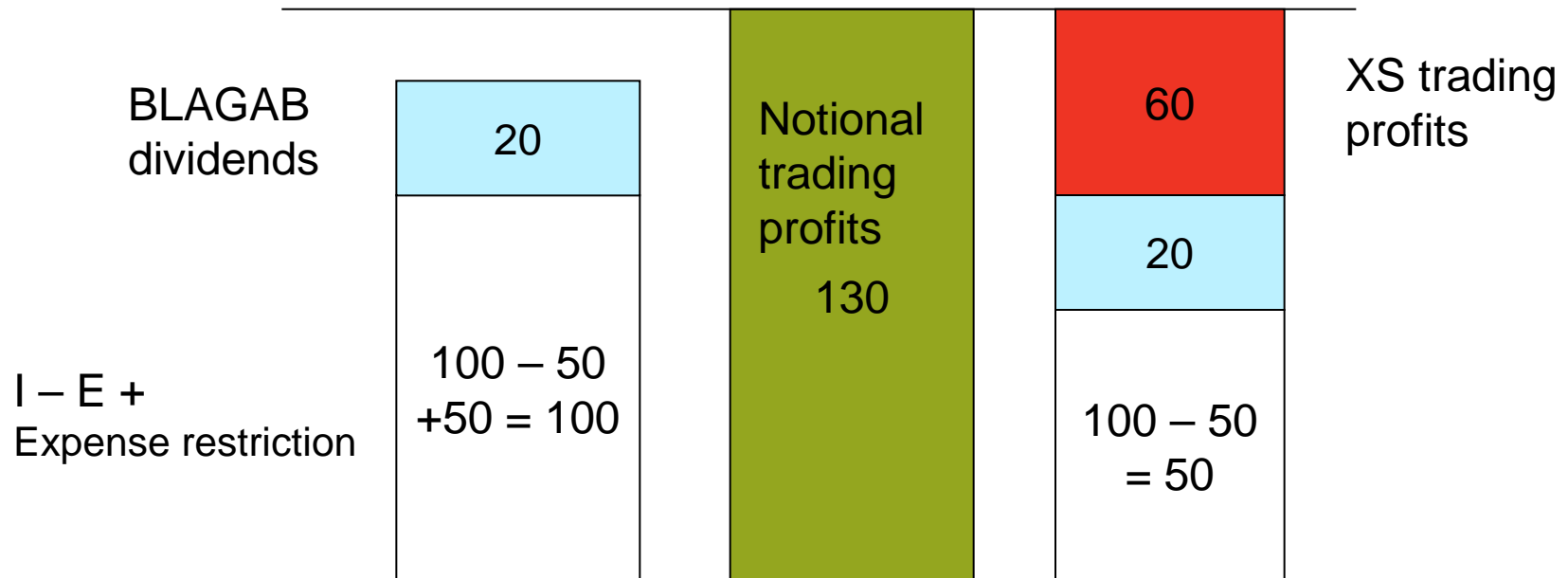
Simple example: Expense restriction (2)



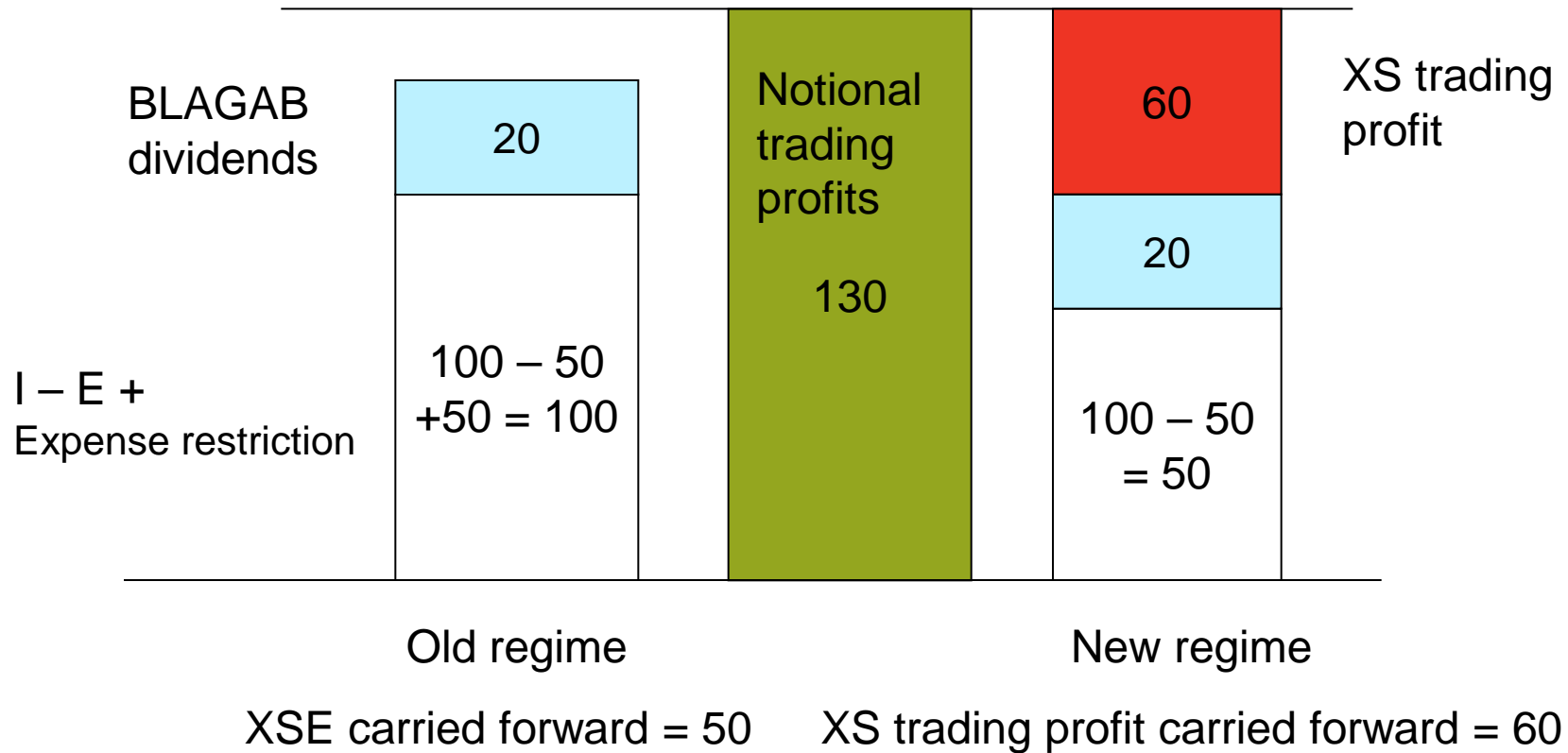
Simple example: Expense restriction (2)

BLAGAB dividends	20	Notional trading profits
I - E + Expense restriction	$100 - 50 + 50 = 100$	130

Simple example: Expense restriction (2)



Simple example: Expense restriction (2)



Use of Notional trade losses

Uses:

- Offset sideways under section 393A ICTA 1988
- Carry back 1 year under section 393A ICTA 1988
- Group relieve under section 402 ICTA 1988
- Carry forward under section 393(1) ICTA 1988

Loss available for surrender x

Consequences of utilizing Notional trade losses

Where a Notional trade loss is either surrendered as group relief or used under section 393A ICTA 1988:

- Firstly, any qualifying (GRB) loss in period is reduced (but not below nil) by the notional life assurance trade loss used, by virtue of s434A(2)(b); then
- If the life assurance trade loss used is in excess of the qualifying (GRB) loss, BLAGAB management expenses are reduced by the excess by virtue of s.76(7) Step 5

Use of notional trade losses carried forward

- All life assurance trade losses are deductible in determining the minimum profits test only (slide 2 of this session)
- Only life assurance trade losses post 31 December 2002 can be used to reduce the amount of shareholders' share of the I minus E profit (under old rules)

The Actuarial Profession

making financial sense of the future

Calculation of Tax Charge



Calculation of tax charge

Taxable I minus E result & GRB result			<u>x</u>
Shareholders' share at full CT rate	x	@ 26.5%	x
Policyholders' share of profits taxable at lower rate	x	@ 20%	x
Total tax charge			<u>x</u>



The Actuarial Profession

making financial sense of the future

Gross Rollup Business Computation



GRB Computations

- Follows principles of trading profit computation

Profit before tax	X
add back disallowables	X
deduct capital allowances	(X)
Trading Profit	<u><u>X</u></u>

- Only taxes the shareholder profit
- Ring-fencing of losses, (prior to FA07 each category of Case VI business streamed, now only carry forward PB losses streamed)

GRB Computations

			£
Opening liabilities			X
Premiums			X
Investment return (linked plus apportionment)			X
			<hr/>
			X
Claims including annuities	X		
less bonuses paid in anticipation	<u>(X)</u>		
		X	
Expenses		X	
Closing liabilities (exc bonuses)		X	
		<hr/>	
			(X)
Pre-tax surplus			X
Bonuses declared			(X)
Disallowed expenses			X
Policy holders' overseas tax			(X)
GRB profit			<u><u>X</u></u>

GRB losses

Prior to FA 07 Case VI (now GRB) losses could only be carried forward and set off against the Case VI (now GRB) profit of the same category of business (i.e. PB / OLAB / ISAB / CTF / LRB).

Post FA 07 the GRB business are all amalgamated as Gross Roll Up

Business. However

- PB losses carried forward at 1.1.07 must be streamed and use is restricted to the ratio of PB mathematical reserves to total GRU mathematical reserves
- All other GRB losses can be used against all GRU business profits, i.e. ISAB losses brought forward can be used against all GRU profits

Sources of information

Liabilities	Forms 51 to 54 statutory FSA return for current and prior period
Premiums	Form 41 statutory FSA return for period
Investment	apportionment of total investment return brought into account, in accordance with section 432C and/or 432E ICTA 1988
Claims	Form 42 of statutory FSA return
Expenses	expected to be allocated to the same categories as per Form 43 of FSA return
Bonuses	Form 58 of FSA return

Simple example: PB loss streaming FA07

BLAGAB income & gains	110
BLAGAB expenses	50
GRB profit	50
UK Dividends	20
Shareholder proportion of dividends	50%
Notional trade profits	110
PB losses brought forward	30
PB represents 50% of the GRU business	

Question 1: What is the PB loss carried forward

Question 2: What is the XS trade profit carried forward under FA 07?

Answer

XS trading profit	5	Notional trade profits 110
BLAGAB dividends	20	
$I + G - E$	$110 - 50$ $= 60$	
GRB	25	

The Actuarial Profession

making financial sense of the future

Case Study Parts 3 & 4





The Actuarial Profession

making financial sense of the future

Review of Case Study Parts 3 & 4





The Actuarial Profession

making financial sense of the future

Tax Modelling and Planning



Trevor Flanning

Tax Modelling and Planning

Agenda

- Tax modelling
- Tax planning
- Treating customers fairly

Tax Modelling

Potential areas requiring tax modelling

- FSA regulatory valuation
- FSA realistic valuation
- ICA
- International Financial Reporting Standards
- US GAAP
- Traditional Embedded Value
- Market Consistent Embedded Value
- Product pricing
- Unit pricing
- Solvency II

Tax modelling: by individual business lines or globally?

- Most reserving / profit-testing models (VIPitech, etc, ...) allow for tax assuming no other lines of business have been written
- ... which is a good practical approach
- But an office's tax calculations are done at global level
- ... and the overall tax bill isn't the same as the sum of the parts
- These interactions are important!

Examples

- May not recognise special tax issues in the projection period
- What part of shareholders profits are franked and so do not get taxed?
- Are you giving relief on expenses that you are not achieving?
- Are you allowing for deferral of relief on any projected losses?

The “approximate way” for allowing for tax in practice

BLAGAB

Pensions/
Gross roll up

End piece calculation

Tax on shareholders
profits 8ish%

Tax on shareholders
profits at 27%

Modelled in policy
projection routines
(VIP)

Tax on policy income
less expenses at
20%

Modelling limitations

Other shortcomings of projection models:

- BLAGAB expenses assumed always relieved
- Investment losses not assumed to occur
- BLAGAB capital gains simplistically modelled
- Brought forward tax assets modelled manually

Actuarial calculations: allowing for tax

Valuation tax rates: Peak 1

- Purpose: Future investment return earned on assets held to meet future benefits is taxable for some products. Hence the use of future investment return net of tax.
- No s/h profits expected on statutory basis. Any profits that do arise can cover tax attached to them.
- BLAGAB
 - Expenses and taxable income: net of tax at 20%
 - Check if XSE. If so, then a prudent tax rate required.
- Gross roll-up business: Income and expenses gross of tax
- Tax provisions:
 - Provision held for unrealised indexed gains
 - Provision held for deferral of notional gains on collective investments vehicles
 - No tax asset allowance for XSE
 - No tax asset allowance for deferral of initial expenses
 - No tax asset allowance for carried forward losses

Actuarial calculations: allowing for tax

RBS (Peak 2)

- Use of global model for stochastic runs is impractical, and so limitations are:
 - Manual adjustments are not practical
 - Economic scenarios generate gains **and losses**. Tax modelling in projection routines rarely allows for deferral of tax relief on losses
 - Losses typically complicate the tax calculation (e.g. interaction between the relief of Case VI losses and XSE)
- So in the stochastic runs, all you have is the ‘approximate approach’ which:
 - Doesn’t work if XSE
 - Doesn’t get s/h FII correct; and
 - Assumes all losses can be relieved immediately

Actuarial calculations: allowing for tax

ICA (Pillar 2)

- For deterministic projections ensure that valuation date stress tests (e.g. market falls) that cause losses are taken into account in the prospective tax calculations.
- For stochastic projections you will have the same limitations as for the RBS calculations but perhaps more severe.
- Under stress for equities, the loss may be crystallised and so a loss of indexation relief.

Actuarial calculations: allowing for tax

Embedded Value Reporting

- Traditional EV/ Market Consistent EV / Appraisal Values
- Use 'the approximate' approach
- Value of XSE (~20%?)
- Value of Gross roll-up losses (~20%? 8% previously obtained)
- Tax on shareholders' profits at 27%
- Further falls to 26%/25%/24%23% scheduled

Accounting

- IFRS & US GAAP
- Include DAC & DIL
- US GAAP has discounting of tax liabilities, IFRS does not

Unit pricing

- Allowance for unrealised capital gains

Actuarial calculations: allowing for tax

Solvency II

- Similar to ICA
- SII base position
 - Policyholder tax allowed for in best estimate liabilities
 - Shareholder tax held outside of best estimate liabilities as DTL but typically modelled as 8% or 28% to the change in surplus and so misses the complex interactions with I-E and exempt dividends;
 - Change in level of deferred tax assets/liabilities to reflect a shift in surplus (SI to SII) relative to the tax basis.
- SCR
 - loss absorbency of deferred taxes (DTL) in relation to trade profits to reduce SCR
 - Possible offset from new business or risk margin?

Apportionment - example

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

With-profits fund with:

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

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

Apportionment - example

Apportioned allocation	Gilt Income	Equity Income	Tax
£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

Tax planning

Objectives for actuaries

Forward looking

- Identify future potential tax issues
- Look for opportunities to maximise tax relief
- Are there any timing issues?
- Use deterministic projections – aids understanding
- Use stochastic projections – indicates potential probabilities

Tax planning

Examples

- Obtaining value for XSE
- Impact of each type of new business product
- Impact of new business volumes
- Benefiting from UK dividend income
- Impact of apportionment rules
- Anticipate impact arising from expected legislation changes
- HMRC clearance needed on innovative structures
- Tax aspects of Part VII and other M&A transactions is always a significant item to consider in detail
- Transition to Solvency II

Value of tax assets

Tax assets include the following:

- Unrealised/realised losses in unit funds
- Unrelieved expenses (XSE plus deferred relief on acquisition expenses)
- GRU losses
- Trade (formerly) NC1 losses
- Excess adjusted Case I profits

Assets may exist at the calculation date or may arise in the future.

Many tax assets will be relieved by equity market growth.

Many tax assets are generated by significant falls in equity markets.

Treating customers fairly

Examples

- Unit fund deferred tax provisions
 - Timing on realisation of gains
 - Allowing for relief on losses and at what rate
 - Consistency between fund and company
 - Principle 4.5.9 in ABI Guide
- Asset share deductions
- Allocation of tax in accordance with Part VII or Schedule 2C schemes
- Allocating tax to with-profits business
 - COBS 20.2.27: A firm must not charge a contribution to corporation tax to a with-profits fund, if that contribution exceeds the notional corporation tax liability that would be charged to that with-profits fund if it were assessed to tax as a separate body corporate

Principles in the ABI Guide

4.5.9 Where the fund is subject to tax the following principles should apply:

- Policyholders should be treated fairly.
- The firm's approach to tax should, as far as possible, be consistent with any information or commitments given in marketing literature or policy documents.
- The basis of taxation chosen should aim to achieve broad equity between generations of policyholders and fairness between the company and the fund, supported by appropriate reconciliation to help ensure that a fair outcome has been achieved. (+)

(+) Without perfect foresight it will not be possible to achieve perfect equity, but the goal should be to balance the interests of different generations of policyholders and achieve a fair allocation of the burden.

The Actuarial Profession

making financial sense of the future

Afternoon refreshments





The Actuarial Profession

making financial sense of the future

Current Tax Developments



Mike Allen

Topics

- New life tax regime under Solvency II
- Corporation tax rate changes
- Branch exemption
- Electronic filing

New life tax regime - consultation

- “A new corporate tax regime” paper issued 5 April 2011
- Closing date for comments 28 June 2011
- Open meetings April to July 2011
- Also life issues working groups
- Draft legislation promised last quarter 2011
- Legislation in FB2012
- New regime from 1 January 2013

New life tax regime – key features

- Accounts will be starting point
- Separate BLAGAB (I-E) and GRB calculations
- Minimum profits test applied to I-E
- Protection business and PHI included in GRB
- Factual apportionments to be agreed with HMRC
- Tax deduction for bonuses and FFA or UDS tax effective
- Single method for policyholder tax deduction
- For mutuals no change to underlying principles

New life tax regime – uncertainties

- Identification of trading profits
 - Allocation of gains
 - Shareholder fund assets
 - I-E volatility
 - Loss carry forwards
 - Transitional adjustments
 - Transfers
-
- Impact of accounting changes (IFRS phase II)

Corporation tax rate changes

Announced changes to UK corporation tax rate:

- Reduces from 28% to 26% from 1 April 2011
- Further reductions at 1% per year down to 23%

Impact on accounts:

- UK GAAP/IFRS - apply once substantially enacted
- US GAAP - apply when enacted

Reserving and pricing impacts:

- MCEV - can use announced rates
- Unit pricing – ensure new rates used from date they apply

Branch exemption

- UK taxation becoming more territorial
- Moving from credit to exemption regime for overseas branches
- Elect in to exemption regime
- Start date subject of detailed rules

- Also changes to controlled foreign company rules

Electronic filing

- Tax filing for periods ending after 31 March 2010 must be filed electronically (from 1 April 2011)
- Tax computation and accounts must be tagged to a taxonomy
- Regulatory return included as pdf
- Tax must be paid electronically

Disclaimer

The information contained herein is of a general nature and is not intended to address the circumstances of any particular individual or entity. Although we endeavour to provide accurate and timely information, there can be no guarantee that such information is accurate as of the date it is received or that it will continue to be accurate in the future. No one should act on such information without appropriate professional advice after a thorough examination of the particular situation.



The Actuarial Profession

making financial sense of the future

Questions

