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Introduction

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11 December
2014

Topics

- Concepts
- History
- Tax policy considerations
- New regime
- Future predictions

Concepts

Proprietary / Mutual

Policyholder / Shareholder

HMRC < company > policyholders

Funds

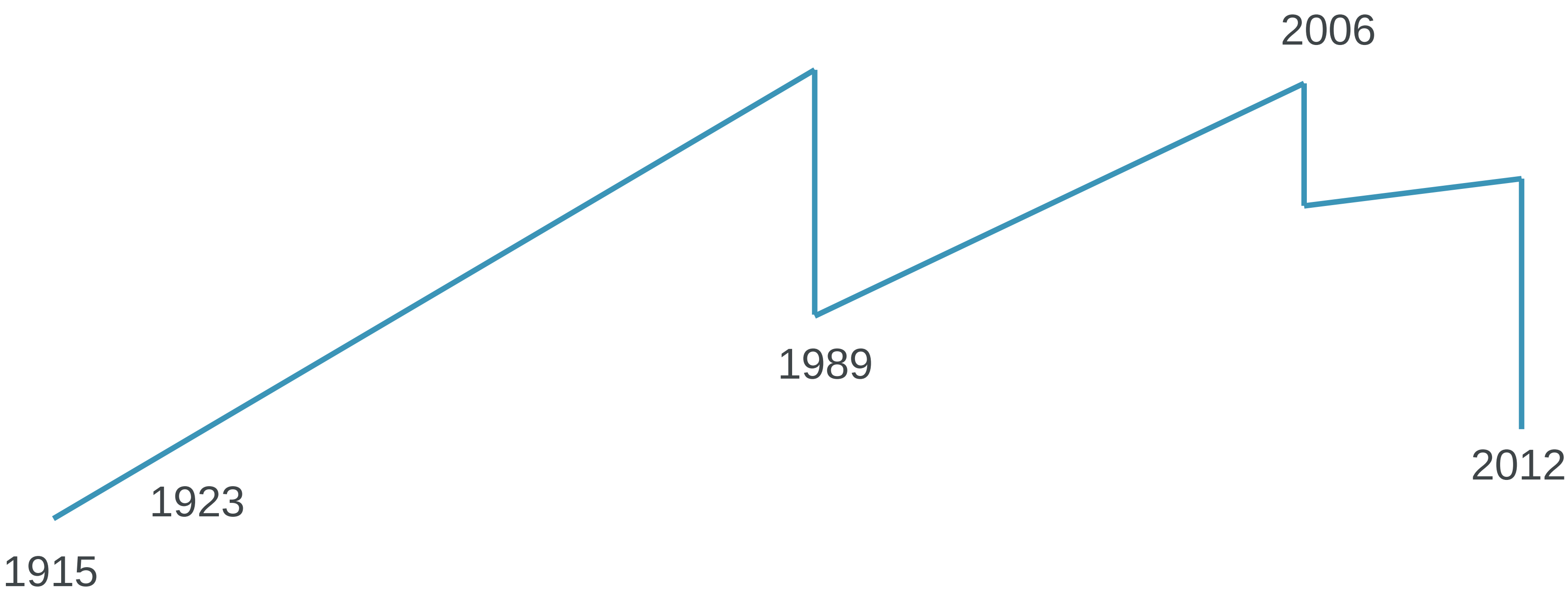
With profit / Non profit

Products

Categories

History

Illustration of complexity over time (not to scale)



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Tax policy

- Insurance and savings generally supported
- Playing field: insures v investment managers
- Tax advantage for some insurance business is a matter of policy
- E, E, T approach to pensions
- Tax policyholders and shareholders

New regime

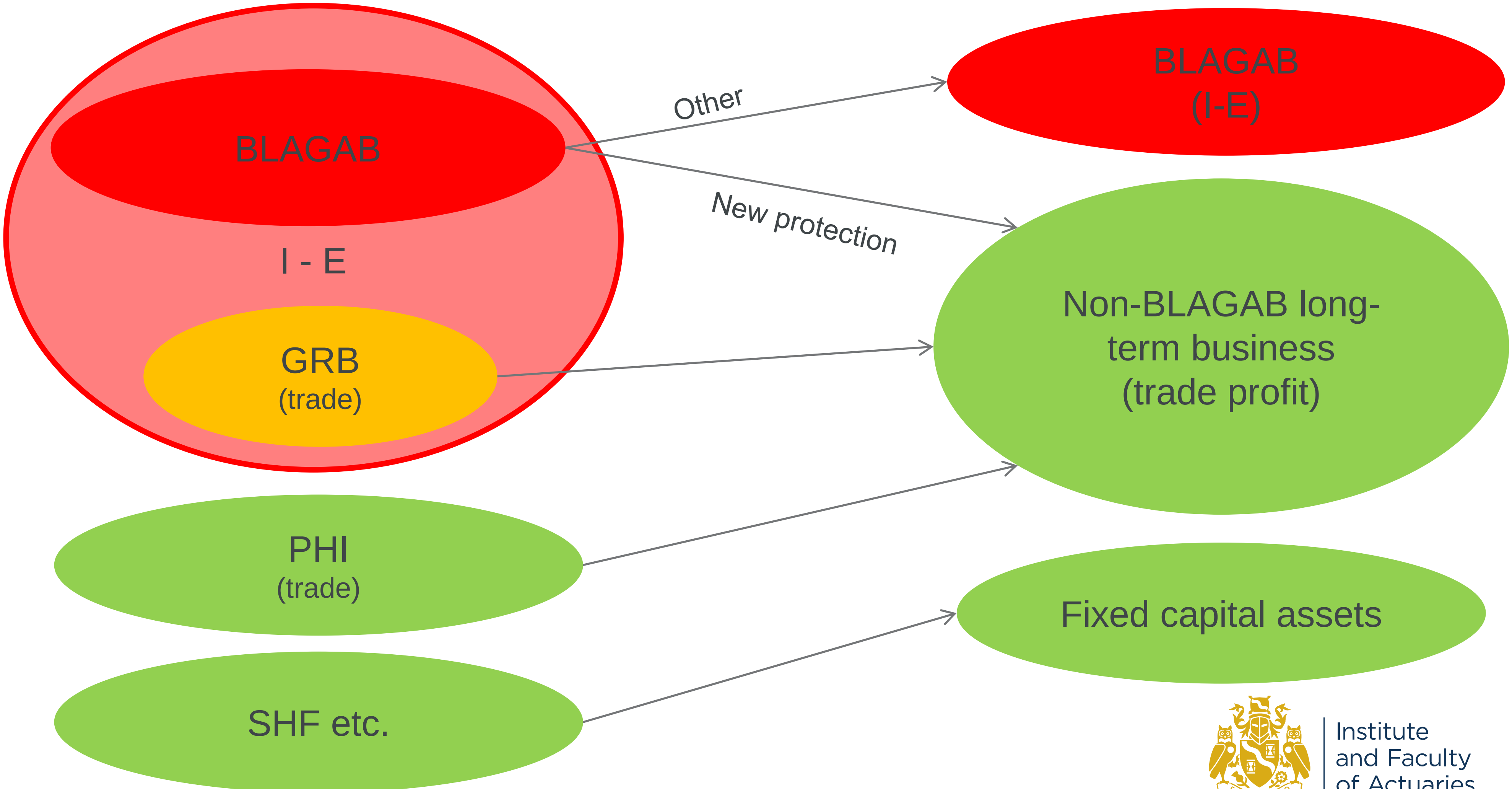
Three changes to bear in mind:

A = accounts starting point

B = business categories, now only two

C = commercial allocation

Schematic old and new regimes



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Future predictions

Direction of travel is simplification

Life company computations could become trading profit calculations like ‘ordinary’ companies by:

- Reducing to one category of business
- Discontinuing I-E basis
- Taxing policyholders on exit

Issues are Treasury cost and existing contracts

Timeframe?

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I-E calculation

Chris Alderson

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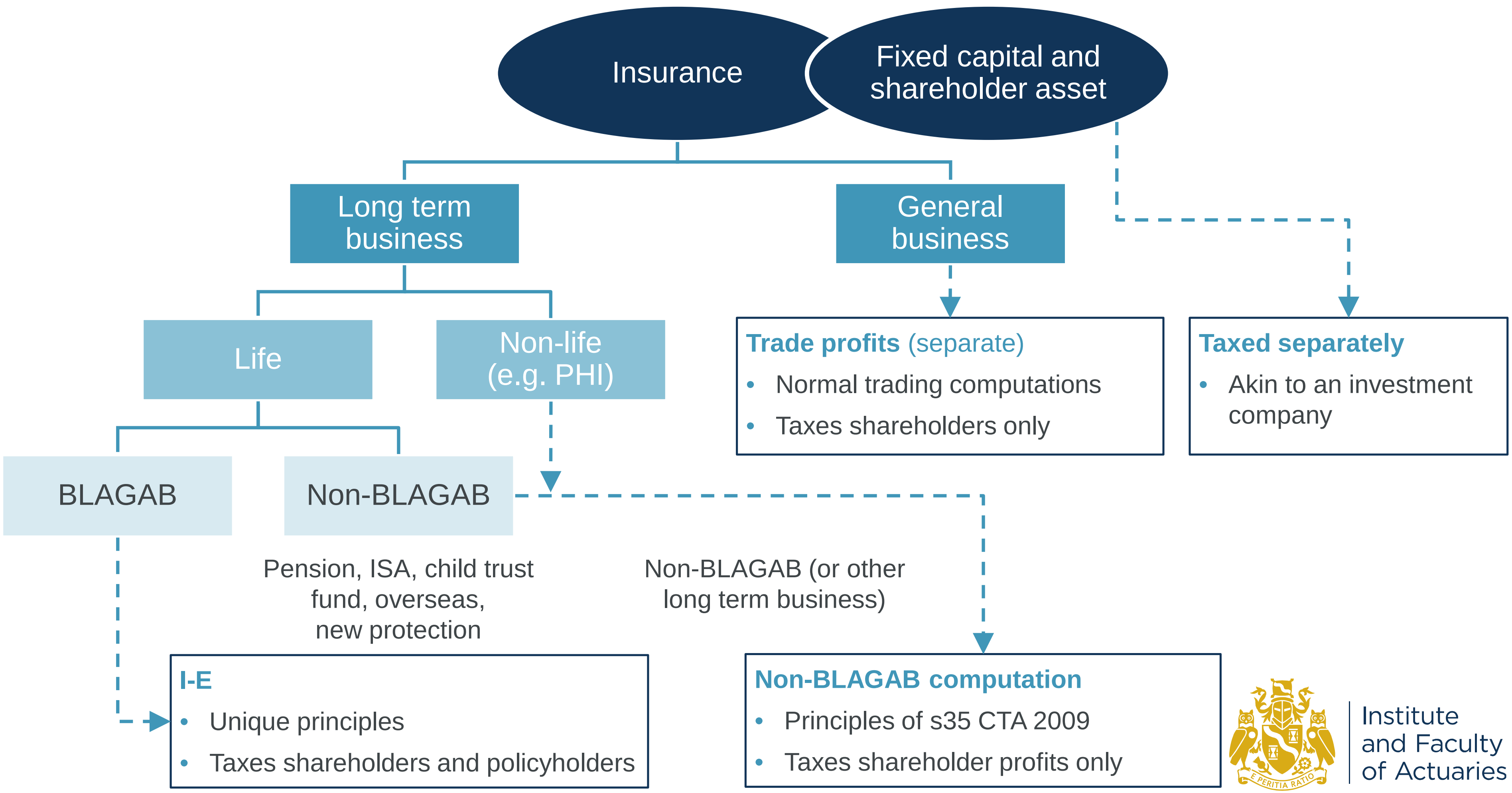
Basis of taxation – schematic



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Non-BLAGAB business

Category	Clause	Brief definition
Pensions Business	58	• Registered schemes or reinsurance of
Life Reinsurance Business	57(e)	• Reinsurance of life business other than PB
Child Trust Fund Business	59	• Per CTF Act 2004
Individual Savings Account Business	60	• Defined in s695 ITTOIA 2005
Overseas Life Assurance Business	61	• Non UK policyholder or annuitant, but not excluded business: PB, ISAB or CTFB
Protection Business (2013 on)	62	• See details on next slide
Permanent Health Insurance	63	• Long term accident and sickness cover

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Treatment of protection business

- Contract of long term insurance
- Moves from BLAGAB to non-BLAGAB for contracts on/after 1 January 2013
- Benefits payable cannot exceed premiums, except:
  - On death
  - On incapacity (e.g. accident or sickness)
  - Where excess is insignificant proportion of premium
  - Where a reasonable person would not expect an excess
- Ignore non-repayable inducements (except money)
- Reassessed if contract varied
- New contract deemed if variation moves policy in/out of definition
- Grandfathering for contracts in force at 31 December 2012

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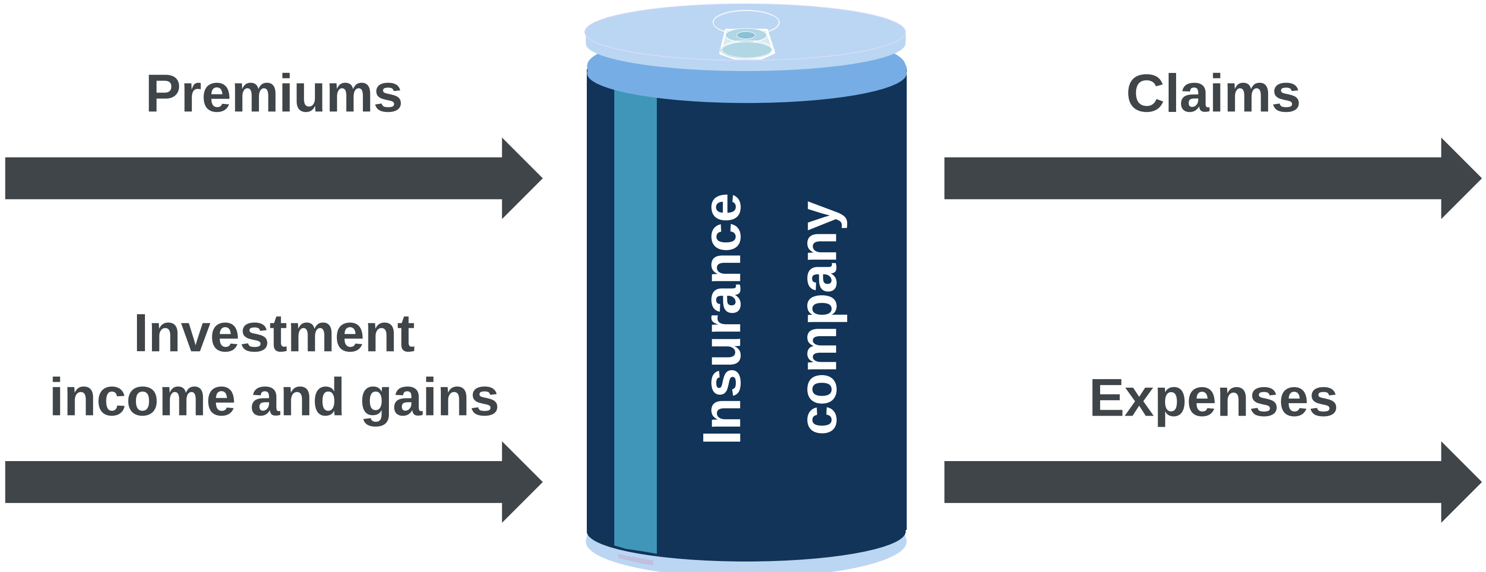
Overview: Terminology – payment flows



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Overview: I-E objectives

Shareholder return

Policyholder return

Tax company profit and policyholder return

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Overview: I-E objective – profit flows

Shareholders retained profits

profit

Insurance fund

return

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1. Overview: I-E rationale

$$P + I - E - C = SP$$

$$C - P = PP$$

$$I - E - (C - P) = SP$$

$$I - E - (PP) = SP$$

$$I - E = SP + PP$$

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Overview: I-E rationale

	Company/Shareholder	Policyholder	Total
Premiums	P	(P)	
Investment return	I		I
Claims	(C)	C	
Expenses	(E)		(E)
Opening liabilities	OL	(OL)	
Closing liabilities	(CL)	CL	
Bonuses	(B)	B	
Profit to company/shareholder	$X_{surplus}$		
Return to policyholders		X_{Profit}	
Total X_S+X_P			I-E

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Basic I-E calculation

BLAGAB income	1,000
BLAGAB gains	200
BLAGAB expenses	(700)
I-E profit	**500**

Divided between policyholders and shareholders share

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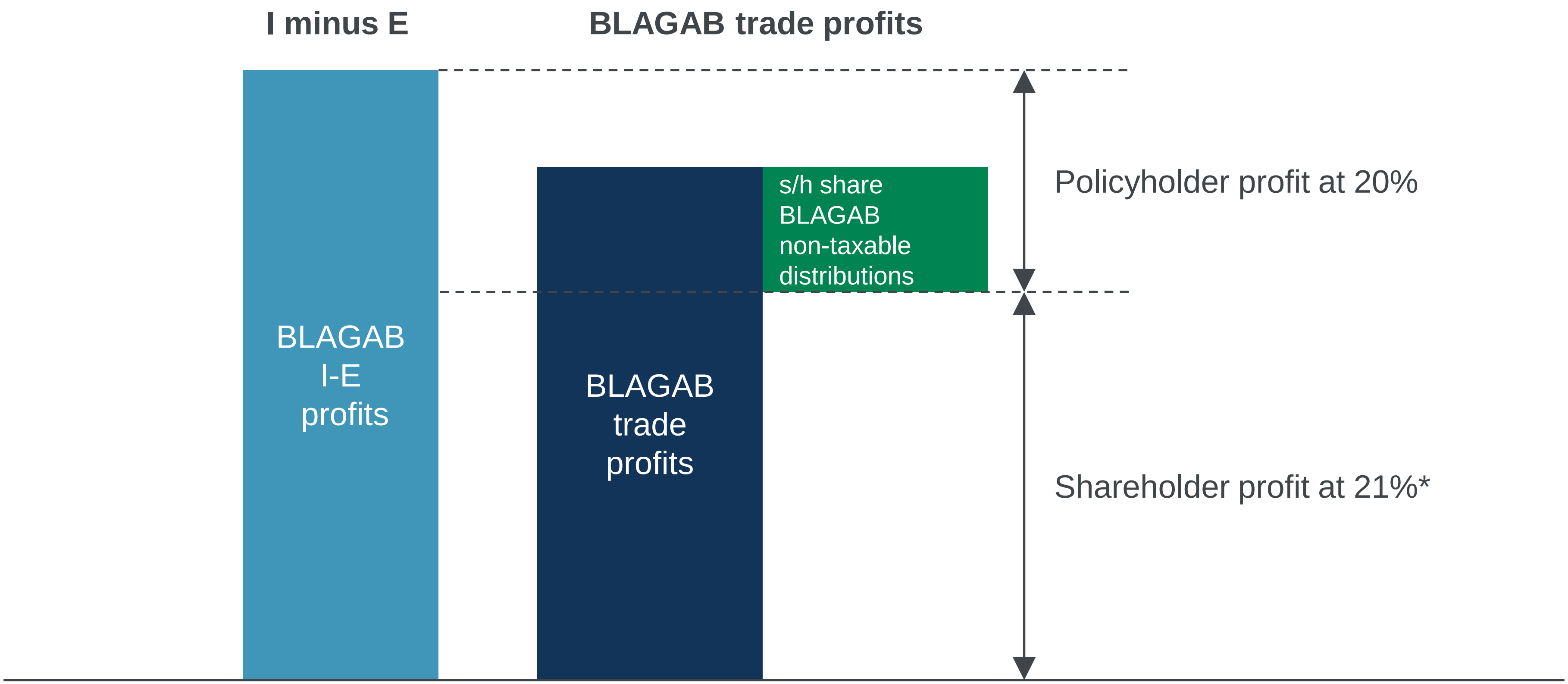
Comparison of I-E and BLAGAB trade profits



*Per 2013 Budget
21% from 1 April 2014
20% from 1 April 2015

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I-E calculation – overview

- Use company account figures (UK GAAP or IFRS)
  - Replaces regulatory return as source
- Allocate income and gains to categories according to commercial allocation per company's books
  - Replaces formulaic allocation of non linked income
- Normal tax rules apply
  - e.g. CGT, dividend exemption
- Allocate expenses on accounting basis
  - No change.

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I-E calculation – prescribe steps

Clause 73 FB 2012 sets out a 6 step process	
Step 1	BLAGAB income
Step 2	Net BLAGAB chargeable gains
Step 3	BLAGAB deemed I-E receipts • Not taxed elsewhere • Excess BLAGAB trade profits
Step 4 = I	Less BLAGAB not-trading deficits
Step 5 = E	Less BLAGAB management expenses
Step 6	I-E profit

If I-E result is negative treated as “excess BLAGAB expense” and carried forward to next period expenses calculation

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I-E calculation – income items

Clause 74 FB 2012 sets out items of income	
a	Property business income
b	Loan relationship credits
c	Derivative contract credits
d	Intangible fixed asset credits
e	Non exempt dividends
f	Distributions from unauthorised unit trusts
g	Income from sale of foreign dividend coupons
h	Annual payments not otherwise charged
i	Non UK income not otherwise charged
j	Miscellaneous income

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I-E calculation – chargeable gains

- Clause 75 FA 2012 sets out chargeable gains calculation
  - TCGA 1992 rules apply
  - Special rules for collective investments and 'box' transfers.

Chargeable gains
Less allowable losses of period
Less allowable losses brought forward

I-E calculation – collective investments deemed disposals

- Investment in collective investments such as OEIC and AUTs are not liable to tax on capital gains thus shelter gains from tax (total deferral of tax on gains where life fund was expand)
- Therefore, section 212 TCGA 1992 introduced an annual deemed disposal of holdings in OEIC/AUTs
- Applies to holdings in certain offshore funds to prevent substitution of holdings in offshore investments for onshore investments caught by the charge
- Gains spread forward over 7 years
- Carry back of losses to previous 2 years on LIFO basis.

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I-E calculation – spreading of deemed disposal gains

Year	Gain	2013	2014	2015	2016	2017	2018	2019	2020	c/f
2013	700	100	100	100	100	100	100	100		
2014	2,100		300	300	300	300	300	300	300	
2015	(350)			(50)	(50)	(50)	(50)	(50)	(50)	(50)
2016	1,050				150	150	150	150	150	300
2017	630					90	90	90	90	270
2018	1,400						200	200	200	800
2019	560							80	80	400
2020	490								70	420
Taxable		100	400	350	500	590	790	870	840	2,140

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I-E calculation – chargeable gains: box transfers

- CGT Boxes are anti-avoidance measure to stop gains heavy assets being moved to another category to change taxation result
- Deemed fair value disposal when assets move boxes.

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I-E calculation – ordinary BLAGAB expenses

- Ordinary BLAGAB expenses based on GAAP debits
- Specified excluded items:
  - Amounts of a capital nature
  - Reinsurance premiums
  - Refund of premiums
  - Profit commissions and profit participations
  - Expenses incurred for non-business and non-commercial purposes
  - Payments made in connection with a policy
- Normal corporation tax adjustments apply
  - For example, pensions on a paid basis

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I-E calculation – spreading of acquisition expenses

- Despite accounts including deferred acquisition expenses (DAC) this is adjusted for tax purposes as acquisition expenses are spread over 7 years
- Acquisition expenses defined as:
  - Commission (however described)
  - Any other acquisition expenses
  - Appropriate proportion of other expenses.

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I-E calculation – spreading of acquisition expenses example

Acquisition expenses of year per accounts	=	630
Defer 6/7th of acquisition expenses of year	=	(540)
Relieve sum of the 1/7ths deferred from previous years	=	600
Expense to allow	**=**	**690**

Year	Expense	2010	2011	2012	2013	2014	2015	2016	2017	c/f
2010	700	100	100	100	100	**100**	100	100		
2011	2,100		300	300	300	**300**	300	300	300	
2012	350			50	50	**50**	50	50	50	50
2013	1,050				150	**150**	150	150	150	300
2014	**630**					**90**	**90**	**90**	**90**	**270**
2015	1,400						200	200	200	800
Allow		100	400	450	600	**690**	890			

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Commercial allocation

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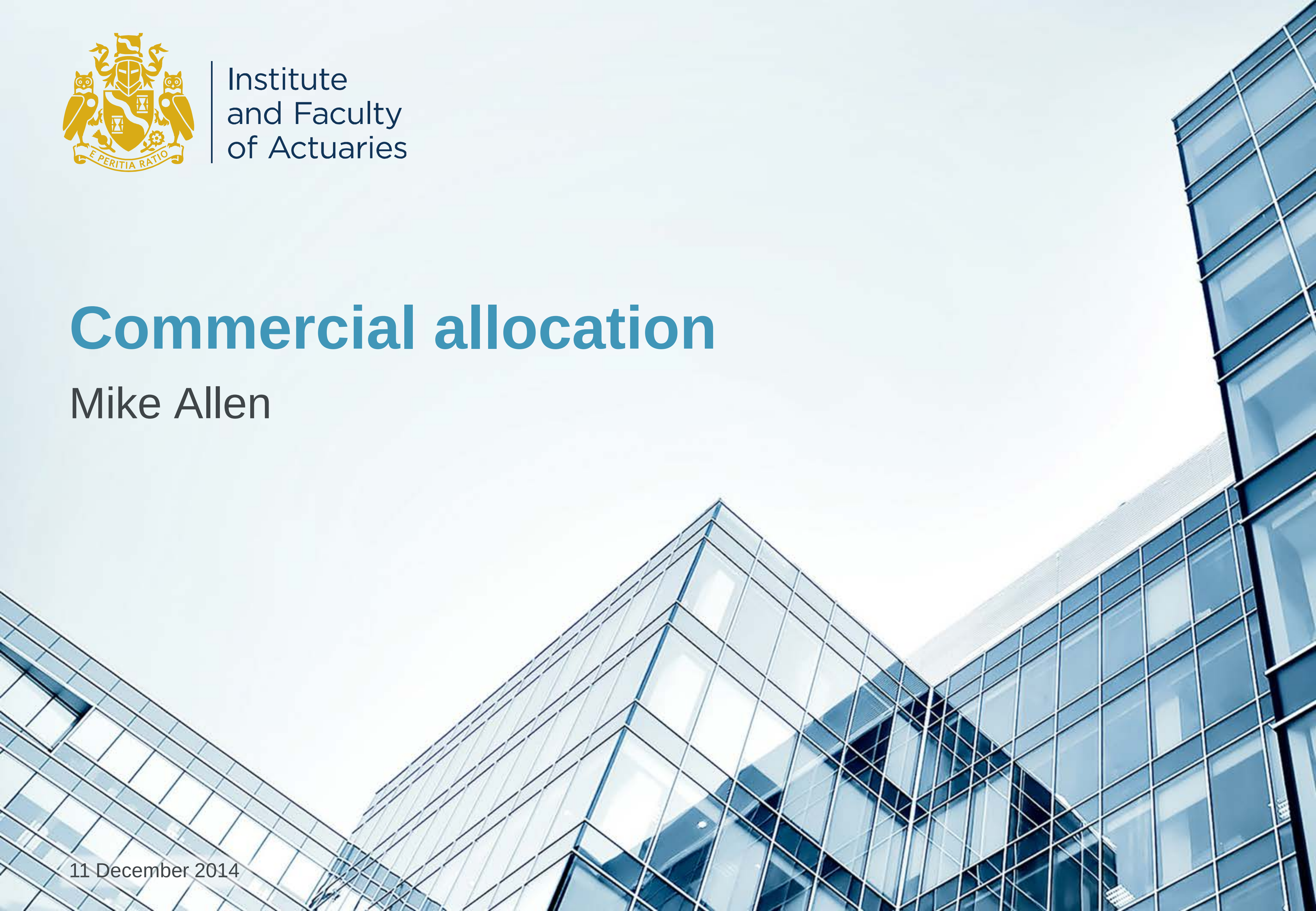

Key requirements of a commercial allocation

Allocate asset income, gains and profit to categories of business

Should reflect how business is run	■ Must be based on commercial reality ■ Likely to involve asset-liability hypothecation (if not a simpler allocation approach can probably be used).
Freedom, not formula	■ No prescribed methodology – it's up to the insurer. ■ However, methodology needs to be agreed by HMRC
Fair to tax categories?	■ Does the allocation methodology give BLAGAB a fair share of income?
Consistency of income, gains, profit?	■ Commercial allocations need to be mutually consistent ■ Does not mean they need to be identical.

Methodologies require actuarial review

Insurer's perspective

- commercial allocation proposals specific to insurer
- should reflect the profile/ peculiarities of insurer
- actuarial teams input involved in shaping proposal

HMRC need to perform critical review of the methodology:

- does it make sense?

-is it a reasonable reflection of the commercial reality?

- is it fair to the tax categories?

HMRC perspective

- have actuarial input, so need actuarial review
- review large number of customer proposals
- able to compare and contrast. Ok in isolation...
- unique big picture view, enabled consistency

Methodology papers

- Most insurer's methodologies agreed by HMRC
- Generally supported by a methodology paper outlining:
- key treatments/judgements,
- justification (including alternatives considered)
- audit trail to accounts
- governance framework: and
- example workings
- Need to monitor any changes in business and adapt methodology as required

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Allocation of income

Relevant for BLAGAB I-E

- Likely to involve actuaries, finance and tax working together
- May be part of the accounts process or separate exercise
- Determine level of review – fund or block of business
- Drill down further to different classes of liability and how assets are allocated to them
- Determine appropriate method to allocate considering complexity and materiality

Note allocation of expenses has not changed from the previous regime – accounts basis used.

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Income allocation issue to consider

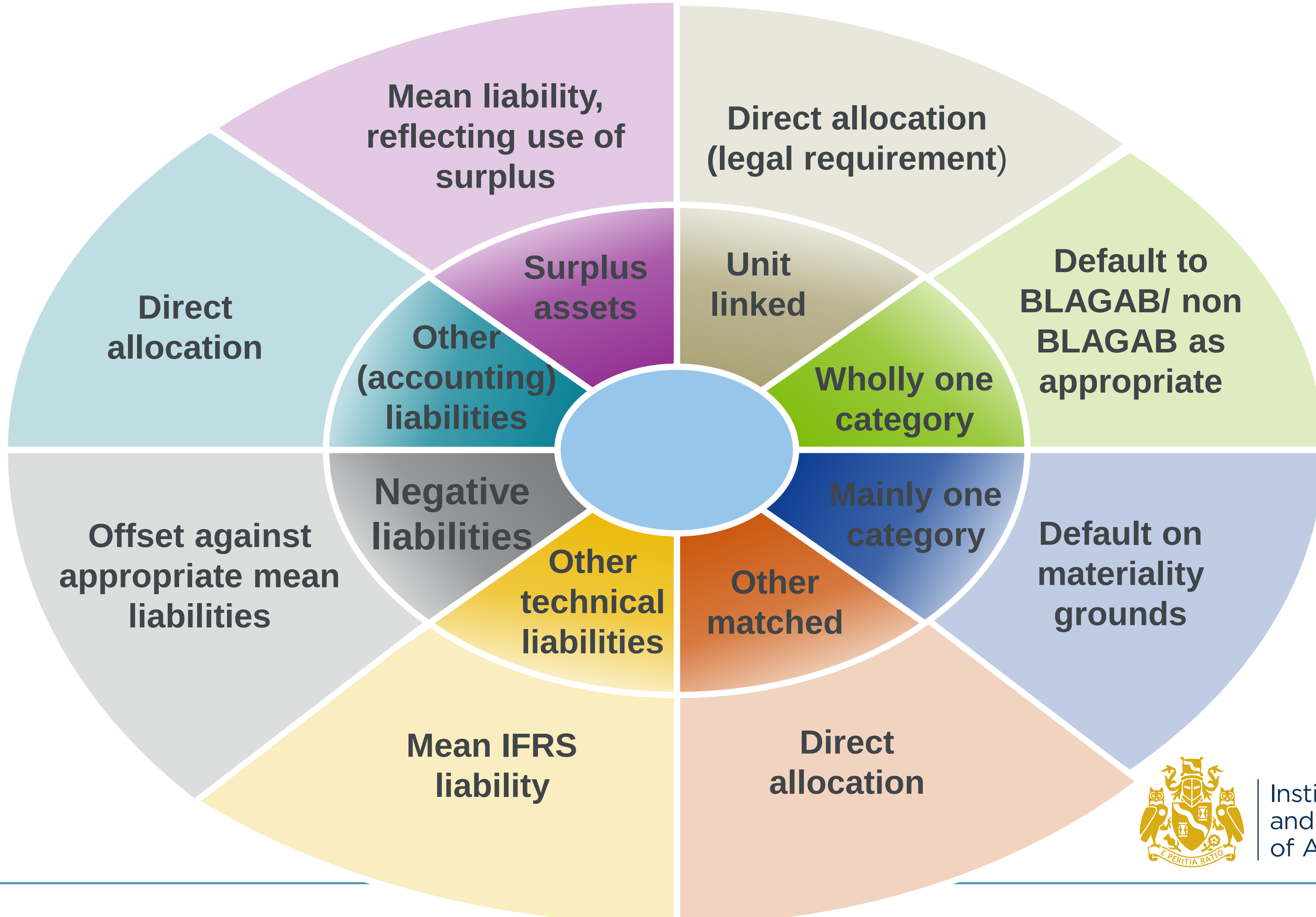
Are liabilities considered sufficiently granular?

- analysis of liability types needs to be sufficiently granular to avoid distorting the tax outcome
- different classes of liability could have quite different tax profiles and the assets hypothecated to them could also be quite different in nature
- lack of appropriate granularity could give rise to inappropriate allocation to BLAGAB

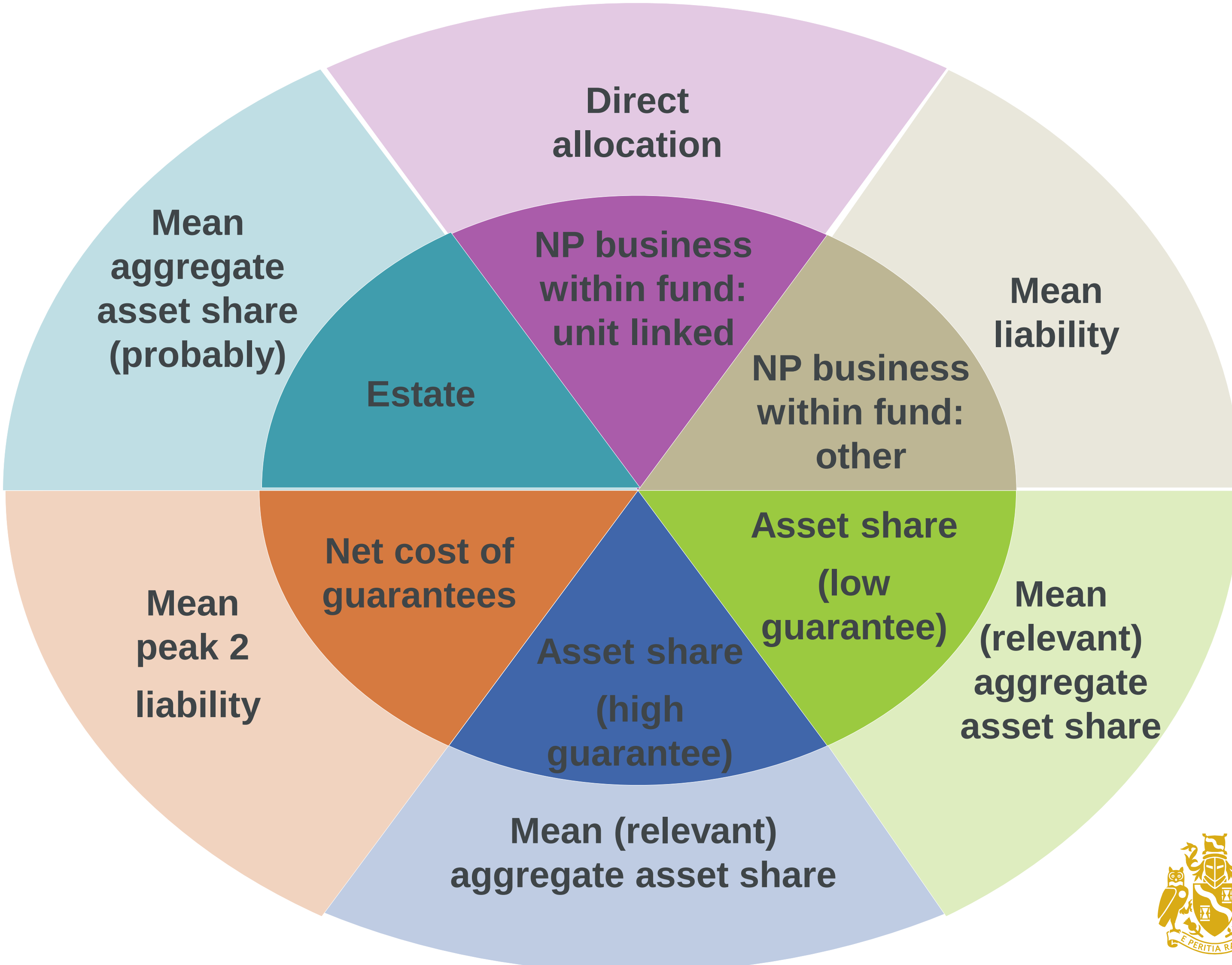
Which assets back other liabilities and which are surplus?

- after considering linked and matched assets, have pools of other assets to back remaining liabilities….and the rest would be surplus
- may use matching rectangle to choose most appropriate assets to get best (lowest) liability result, this would be the commercial reality but does this give a sensible tax result?
- where there is a conflict, should not have separate matching rectangles.

Allocation of income – example non profit



Allocation of income – example with profit



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Allocation of gains

Relevant for BLAGAB chargeable gains calculation only

- Generally similar method used to allocate gains as for income

- Asset matched or partially matched to BLAGAB liabilities - gains allocated wholly or in 'appropriate proportion'
- Otherwise "acceptable commercial method" should fairly represent the contribution assets have made to the business, during the period they have been held.
- Creates an issue where BLAGAB percentage is declining and asset has been held for many years
- Generally insurers have agreed cut-offs or averaging bases

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Allocation of profit

Relevant for - non-BLAGAB trade profit calculation

- long-term business fixed capital profit

- BLAGAB trade profit minimum profits test

- Includes many more items than income and gains
- Premiums
- Claims and movement in mathematical liabilities
- Expenses and movement in deferred expenses
- Bonuses

Issues to Consider - surplus assets

Allocation methodology should consider what the NP surplus is supporting:

– If linked liabilities dominant, does it require proportionate share of surplus? Unlikely

– If non linked liabilities more relevant... mean non linked liability may be appropriate in this case

Allocation methodology for WP surplus assets needs to consider what it is supporting:

– May be to support the WP fund as a whole, or perhaps specific WP liabilities

– Supporting the fund as a whole and closed to new business may suggest mean asset share

– But WP fund may also still be open to new business, with the estate playing a role

– Note the WP PPFM may be specific on the use of the estate

– Beware setting precedent - if commercial allocation implies a specific use and the Board / WPA sign-off on this use, the freedom of operation of the fund may be limited going forward

Issues to consider - further WP issues

- There may be liability subsets with varying levels of guarantee:
  - differing levels of guarantee may correspond to separate asset pools
  - would then expect each asset pool to be considered separately, where material
- There may be a range of distinct WP funds, perhaps accumulated from a number of insurers
  - consistency of method across funds is welcome, where appropriate
  - may have different funds managed in quite different ways......allied with restrictions in aligning fund operations
  - this may then require distinct commercial allocation methodologies across the WP funds
- The WP methodology should also reflect any Scheme of Demutualisation or Re-attribution
- Actuaries ought to be prominent in devising the WP fund methodology.

Validation of commercial allocation

- Check that the agreed high level methodology can be supported by the underlying processes
- Check result can be incorporated in tax calculation with appropriate controls
- If the tax result is erratic is this due to methodology, revision may be needed
- Determine impact on the EV or ICA?
- Agree timetable to review main judgements and approximations. Ensure that their limitations are understood.

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Shareholder tax calculation

Chris Alderson

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Non-BLAGAB trading profits – calculation basis

- Trading profit calculation (with modifications)
  - s35 CTA 2009 applies
  - Plus dividends taxed
  - Asset value changes taxed rather than capital gains
- "Gross roll up" basis
  - No tax on investment return to policyholders
  - Shareholder profits taxed at corporate tax rate
  - Applies to mutual insurers but any profit exempted from tax

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Non-BLAGAB trading profits – calculation principles

- Identify non-BLAGAB accounting profits and losses
  - Use acceptable commercial method to allocate between BLAGAB and non-BLAGAB
  - Should fairly represent non-BLAGAB contribution to total profits
  - Include allocation of unmatched items
  - Apply fiscal adjustments (see next slide)
- Method must be consistent with allocation of income and gains to I-E
- To be agreed with HMRC
- Regulation making powers in FB 2012.

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Non-BLAGAB trading profits – fiscal adjustments

- Include:
  - Dividends taxed notwithstanding general exemptions
  - Movement in index-linked gilt-edged securities
  - Profit/(losses) on assets moving from non-BLAGAB to BLAGAB
  - Transitional adjustments
  - Pre 2013 non-BLAGAB DAC amortisation.
- Exclude:
  - Receipts and expenses on long term business fixed capital
  - Profits/(losses) on intra-group insurance business transfer schemes

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Non-BLAGAB trading profits – application to with profit funds

- Profit allocations
  - With profit funds often managed as single pool of assets
  - Time consuming to identify shareholder return by category
  - Total shareholder return is identifiable
  - Allocation needs to be consistent with form of return
    e.g. bonuses, management fees, guarantee fees
  - So could have several allocation bases in a single fund.

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Purpose of calculating BLAGAB trade profits

Why do we need a calculation of BLAGAB trade profits?

- Only of relevance to proprietary companies, not mutuals
- I-E computation taxes both shareholders and policyholders
- BLAGAB trade profits calculation is required to:
  - Calculate the shareholders' share, or
  - Determine the minimum amount of I-E profit for the period – Minimum Profits Test
- Shareholders' share of I-E profit is taxed at CT rate (currently 21%)
- Policyholders' share of I-E profit is taxed at 20% rate
- Losses can be group relieved.

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BLAGAB trade profit or loss?

Clause 136: Definitions

- A company has a BLAGAB trade profit for an accounting period, if
  - calculated in accordance with ordinary trading rules (s35 CTA 2009)
  - there are profits of the business for the accounting period that
  - but for the requirement to charge under the I-E rules
  - would be chargeable to corporation tax under s35 CTA 2009.

Replicated for a loss

  - This means that s46 CTA 2009 applies and tells us to calculate the profits of the trade in accordance with GAAP.

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BLAGAB trade profit – starting point GAAP profit before tax

- Akin to non-BLAGAB long term business profits computation
- Starting point is GAAP profit before tax – to be allocated to BLAGAB.

	£	**£**
Liabilities brought forward		X
Premiums		X
Investment income and gains		X
		X
Expenses and interest	X	
Claims	X	
Liabilities carried forward	X	
		(X)
GAAP profit before tax		**X**
Tax		(X)
Profit after tax		**X**

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BLAGAB trade profits computation

BLAGAB trade profits computation		
	£	£
GAAP profit before tax		X
Less: Profits of long term business fixed capital	(X)	
Less: Non-BLAGAB long term business profits	(X)	(X)
Profits allocated to BLAGAB		X
Add: Disallowed BLAGAB expenses	X	
Add\(Deduct): Transitional adjustment to new regime (spread over 10 years)	X	
Add: Pre-2013 DAC amortisation	X	
Less: Capital allowances	(X)	(X)
Less: Policyholders' tax – current/cash	(X)	
Less: Policyholders' tax – deferred	(X)	(X)
BLAGAB trade profits		**X**
BLAGAB trade losses brought forward		(X)
Adjusted BLAGAB trade profit		**X**

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BLAGAB trade profit calculation – commercial allocation

- Accounting profit or loss and tax adjustments to be allocated between BLAGAB and other long term business under an **acceptable commercial method**

- Fairly represents the contribution made by those businesses
- See ‘non-BLAGAB long term business profits’ section

BLAGAB trade profit – policyholder tax adjustment

- Policyholder tax – allocable expense in arriving at shareholder profits, i.e. BLAGAB trade profits
- How is it measured?

The old

- Long and tortuous history
- Variety of methods
- Generally only current tax

The new

- **Current tax**
  - cash tax payable at 20% for that period
- **Deferred tax**
  - movement in certain account balances

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BLAGAB trade profit – policyholder tax adjustment, deferred tax

Per GAAP accounts

Closing deferred tax balance for period of account	(X)
Less:	
Closing deferred tax balance for previous period of account	(X)
Tax expense or receipt	(X)

Example

C/F deferred tax liability – per GAAP accounts	(200)
Less:	
B/F deferred tax liability – per GAAP accounts	(120)
Deduction in arriving at BLAGAB trade profits	**(80)**

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BLAGAB trade profit – policyholder tax, deferred tax definition

What is policyholder deferred tax? (clause 108)

BLAGAB matter	+	Calculated ***by reference*** to the policyholder rate of tax
• Excess BLAGAB expenses • Spread acquisition expenses • Other future deductible BLAGAB expenses • BLAGAB allowable loss • Capital losses (unit trust and OEIC deemed disposals) • Unrealised chargeable BLAGAB gains.		• Must be shown in the GAAP accounts.

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BLAGAB trade profit – policyholder tax, deferred tax example

Example – deferred tax account					
Balances – (Dr)/Cr	**Year 1 Closing balance**	**Year 2 Adj to opening balance**	**Year 2 Revised opening balance**	**Year 2 P/L Dr/(Cr)**	**Year 2 Closing balance**
Unrealised gains	500	(50)	450	100	550
S212 spread gains	1,000	-	1,000	(200)	800
Capital losses	(200)	100	(100)	-	(100)
DAE	(300)	(20)	(320)	20	(300)
Total	**1,000**	**30**	**1,030**	**(80)**	**950**
Tax at 20% (net liability)	200	6	206	(16)	190

Net (Cr 10) to profit

What is the policyholder deferred tax deduction for BLAGAB trade profits for year 2?

Example – deferred tax deduction/income	
Closing balance year 2 (liability)	(190)
Less: Closing balance year 1 (liability)	(200)
Policyholder tax receipt for year 2	**10**

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BLAGAB trade profit – two purposes of comparison with I-E profits

- I-E profit split between
  - Shareholders share taxable at full CT rate (21%)
  - Policyholder share taxable at basic rate of income tax (20%)
- Determine the minimum taxable I-E profit (the shareholder profit).

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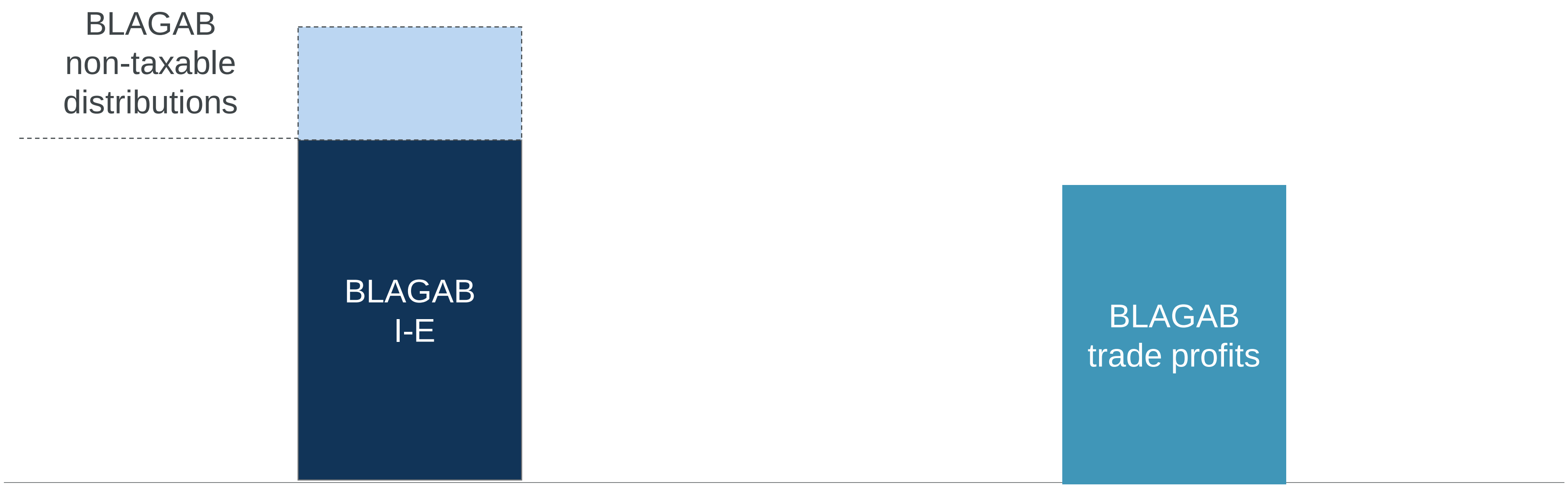
BLAGAB trade profit – comparison with I-E profits, step 1



I-E = policyholder+ shareholder profits

BLAGAB trade profit = shareholder profit

BLAGAB distributions not taxed

BLAGAB distributions taxed

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BLAGAB trade profit – comparison, policyholders' share of I-E profit

How much I-E profit should be allocated to policyholders and how much to shareholders …

Deduction of non-taxable distributions from BLAGAB trade profits

- The policyholders' share of I-E profit is found by deducting the BLAGAB trade profits from the I-E profit
  - Non-taxable distributions are not included in I-E but are included in BLAGAB trade profits, therefore we need to remove the BLAGAB element from the BLAGAB trade profits before doing the above calculation
  - Only deduct the 'shareholders share', as BLAGAB trade profits is shareholder profit only

Shareholders share (*previously known as 'A/B'*)

- The shareholders share is calculated by using the relevant proportion: $\frac{BTP}{BNTD + I}$
  - BTP = BLAGAB trade profits (i.e. shareholders profit)
  - BNTD = BLAGAB non-taxable distributions
  - I = BLAGAB income and chargeable gains (less losses) + miscellaneous receipts + minimum profits charge = steps 1 to 3 (The I-E basis).

- $\frac{BTP}{BNTD + I}$ >= 1 => All shareholder

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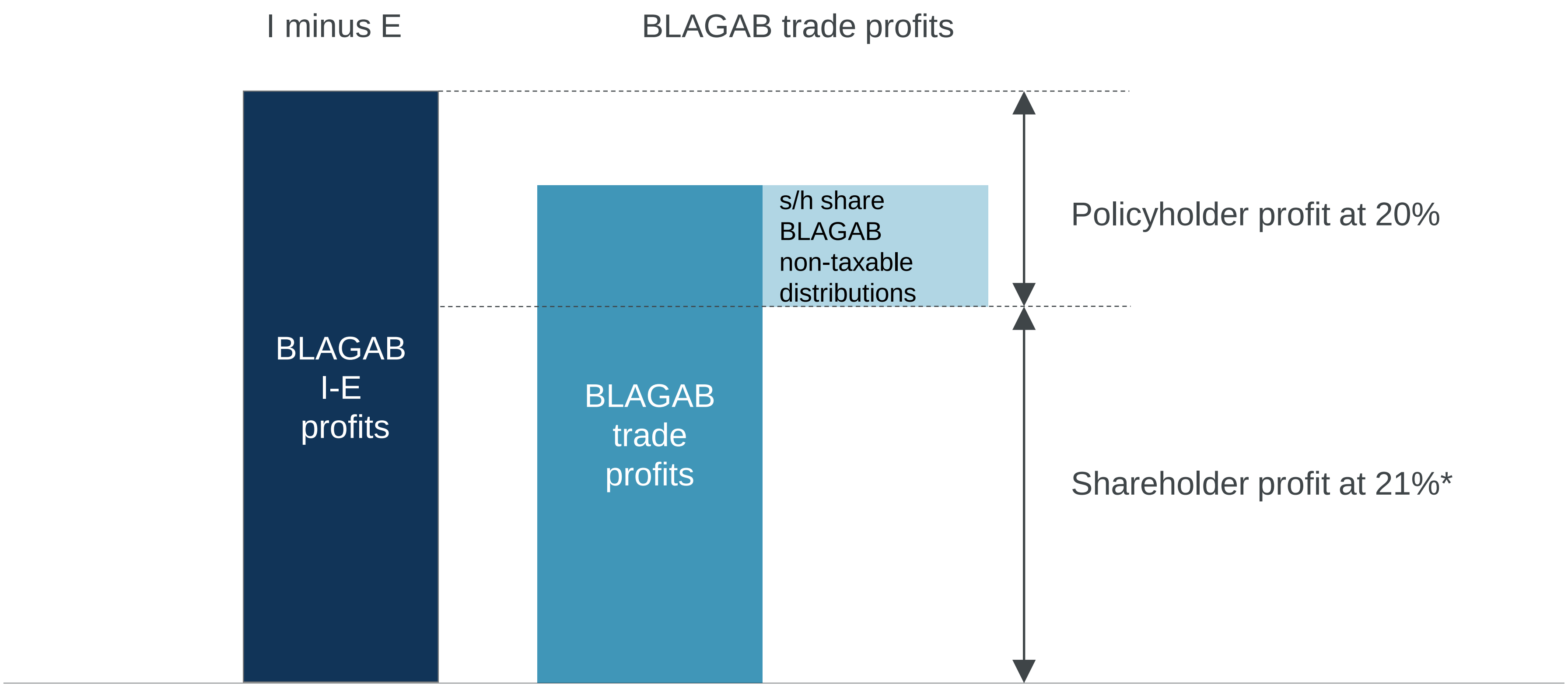
BLAGAB trade profit – comparison with I-E profits, step 2



*Per 2013 Budget
21% from 1 April 2014
20% from 1 April 2015

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BLAGAB trade profit – shareholder and policyholder profits

	£	£	£
Chargeable gains less allowable losses allocated to BLAGAB		6,000	
BLAGAB income		500	
BLAGAB income and gains		6,500	
Relief for non-trading loan relationship deficits		-	
Relief for BLAGAB management expenses		(60)	
BLAGAB I-E profits		**6,440**	
BLAGAB trade profits (after deducting p\her tax)	3,884		
Less shareholder' share of BLAGAB dividends	(330)		
Shareholders profits taxed at 21%		(3,554)	x 21% = 746
Policy holders share of I-E profit (clause 103)		2,886	x 20% = 577
Total tax			**1,323**
Policyholder share			
Calculation of I + BNTD			
BLAGAB income and gains	6,500		
BLAGAB distributions	600		
I + BNTD	7,100		
Shareholders' fraction BTP/(I + BNTD) 3,884/7,100 x 100%	*55%*		
Shareholders' share of non-taxable distributions			
BLAGAB distributions	600		
Shareholders' share 55% x 600	330		

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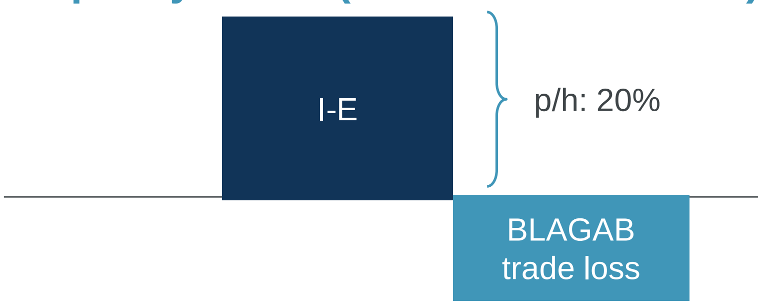
BLAGAB trade profit – examples of different profiles – tax payable at s/h and p/h rates

Part policyholder, part shareholder

All shareholder (BLAGAB trade profits > I-E)

All policyholder (BLAGAB trade loss)



Note 1

XSE profile – where I-E is less than BTP

XSI profile – where I-E greater than BTP

Note 2

The shareholder profiles above do not show the minimum profits adjustment, hence no tax rates are shown

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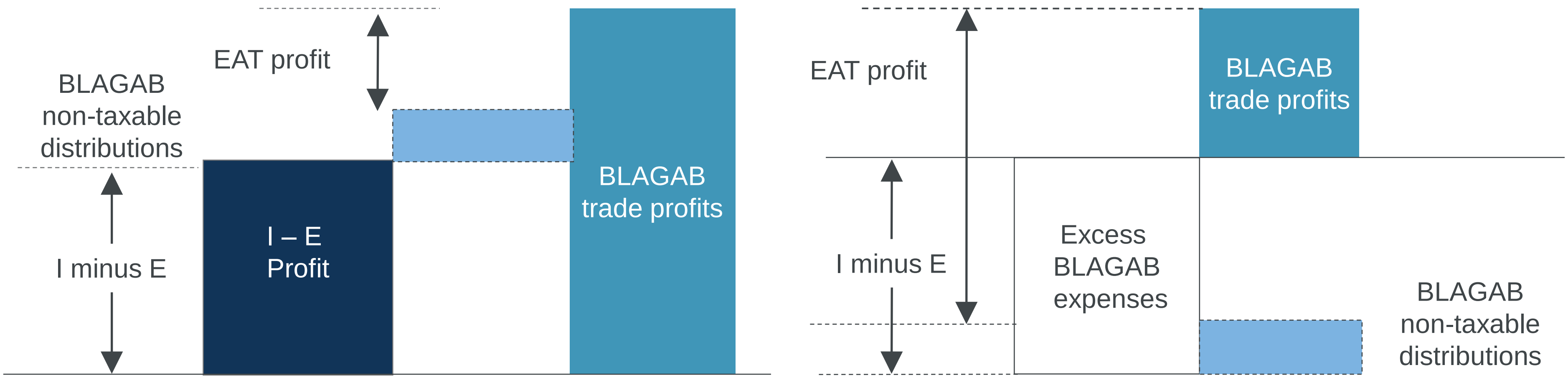
BLAGAB trade profit – calculation of minimum BLAGAB profits

- Comparison of two profits:
  - I-E profit (assessed on I-E)
  - BLAGAB trade profit (notional calculation – unless a loss)
- If BLAGAB trade profit > I-E → I-E increased to level of minimum profits
  - Deemed Income receipt
  - Equal amount of E added to the E carried forward to next accounting period.

BLAGAB trade profit – excess adjusted trade profit



Excess adjusted BLAGAB trade profits (EAT profit)

- Used to calculate minimum profits to be brought into tax
- Add non-taxable BLAGAB distributions to I-E for comparison
- The excess is treated as an I-E receipt
- Management expenses equal to the excess are carried forward to following period.

BLAGAB trade profit – excess adjusted profits example

	BTP > I-E		I-E > BTP	
	Adjustment		No adjustment	
	£	£	£	£
Adjusted BLAGAB trade profit				
BLAGAB trade profit		10,884		4,884
Adjusted in respect of losses		(1,000)		(1,000)
Adjusted BLAGAB trade profit (clause 93)		**9,884**		**3,884**
Calculation of the adjusted I-E profit				
BLAGABI				
BLAGAB income and gains	6,500		6,500	
BLAGAB non-taxable distributions	600		600	
	7,100		7,100	
Less: BLAGAB E				
Expenses deduction	(60)		(60)	
Adjusted I-E profit		**7,040**		**7,040**
Excess adjusted BLAGAB trade profit – clause 93		**2,844**		**nil**

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BLAGAB trade losses – use

How can losses be used?

Clause 123

- Offset sideways
- Carry back 1 year

Clause 124

- Carry forward for proposes of
  - Minimum profits test, and
  - Policyholders tax rate

Clause 125

- Group relieve

Clause 127

- No relief against policyholder share of I-E

Losses available for group relief or s37 purposes Clause 126 restriction	
BLAGAB trade loss for period	100
Less:	
Non trading deficits on BLAGAB loan relationships and derivatives	(20)
Loss available for surrender	**80**

Consequences of using a BLAGAB trade loss

- Deduct an amount equal to the loss used from BLAGAB management expenses

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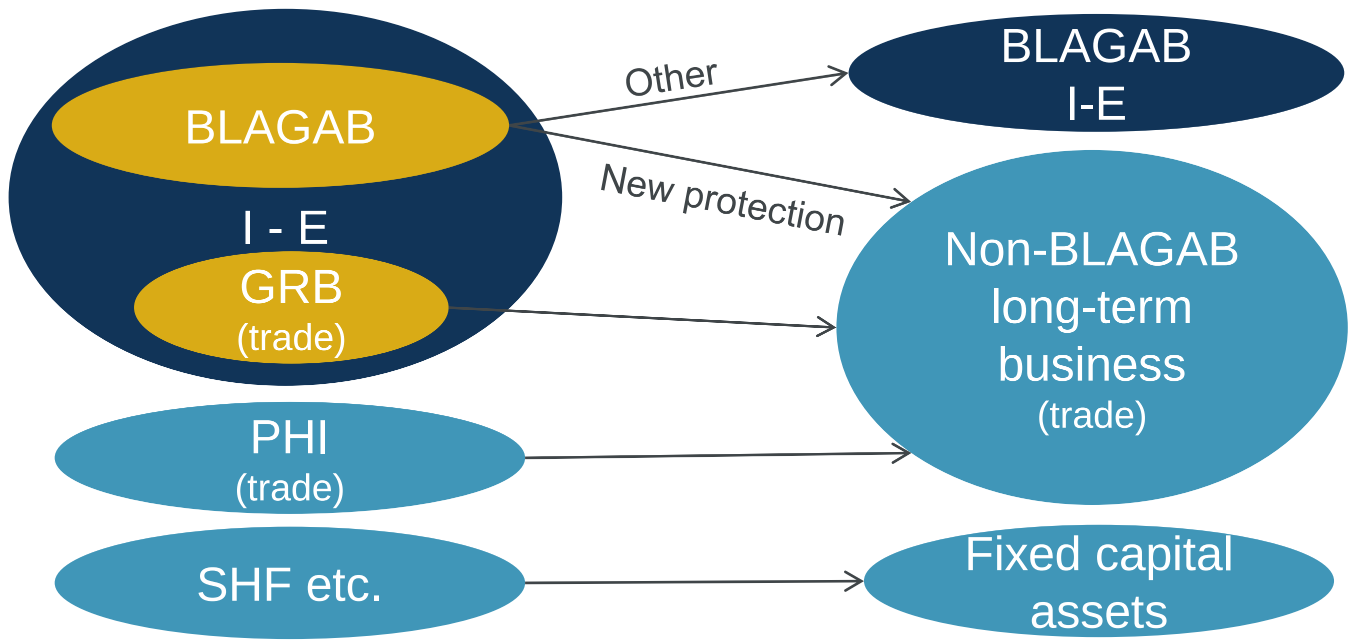
Tax Modelling in the new world

Dan Gallon

11 December 2014

Implications of the new regime for modelling

- Pictorial comparison of old and new regime (and its complexity)



What do changes mean for tax profiles?
How do you take best advantage of simplifications in a practical sense?
How do you proportionately respond to demand for scenario modelling to support SII and Economic Capital modelling?

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Implications of the new regime for modelling

- Drivers which are transforming tax profiles

Single 20% rate from 2015 (enacted 2013)	Post-RDR new business	Run-off of BLAGAB	Determination of 1/1/13 transitional adjustments	No XSE from new protection	GRB and BLAGAB taxed independently

Combine to define a new tax profile for many companies

Fewer complex products. Fewer interactions.

Potential benefits

- Simplify models and processes with proportionate approaches.
- Reduce validation effort around tax.
- Improve accuracy of Model calibration.
- Reduce capital requirements (through recognition of loss absorbency of tax).
- Improved transparency, management information and governance.

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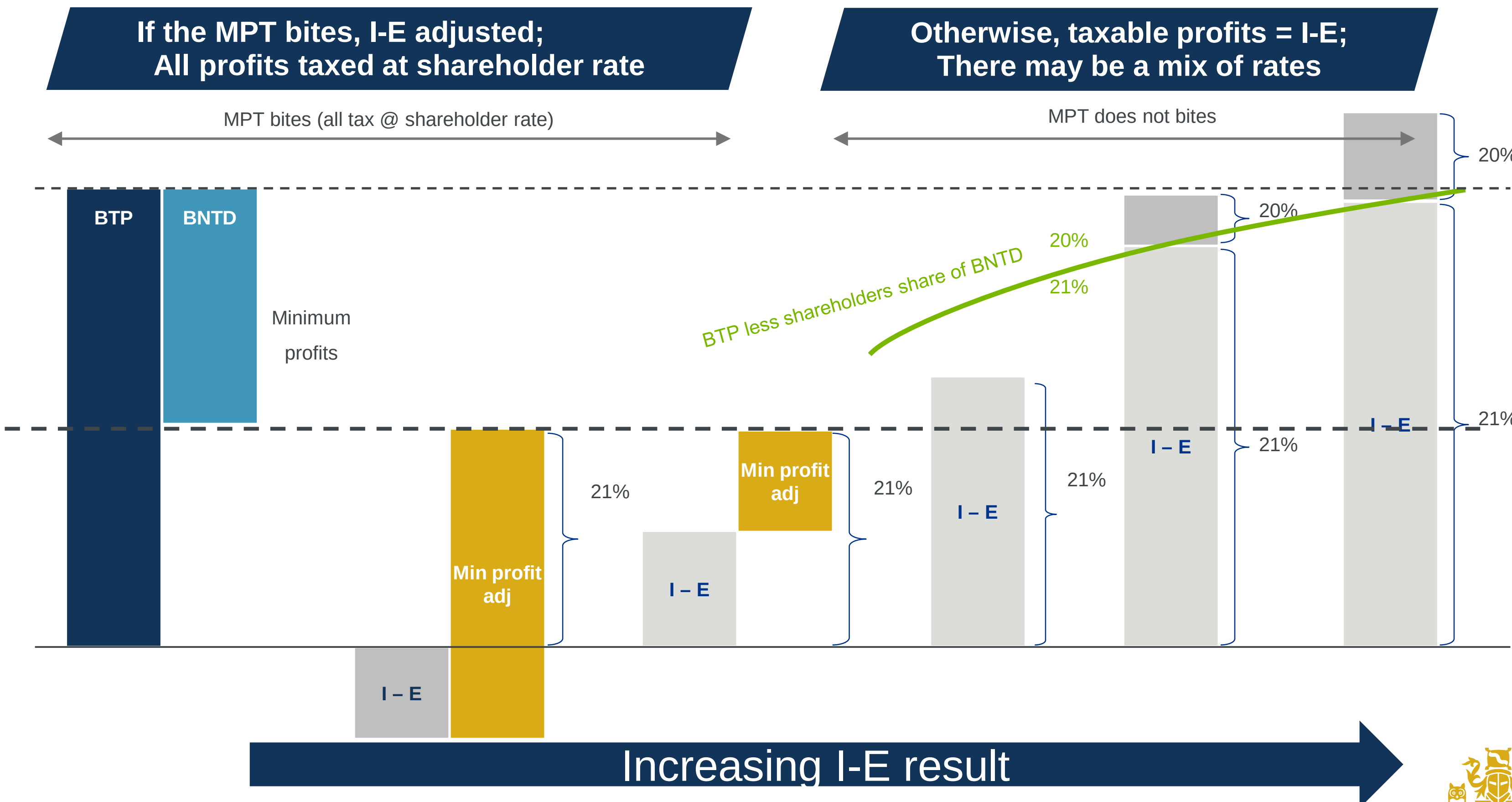
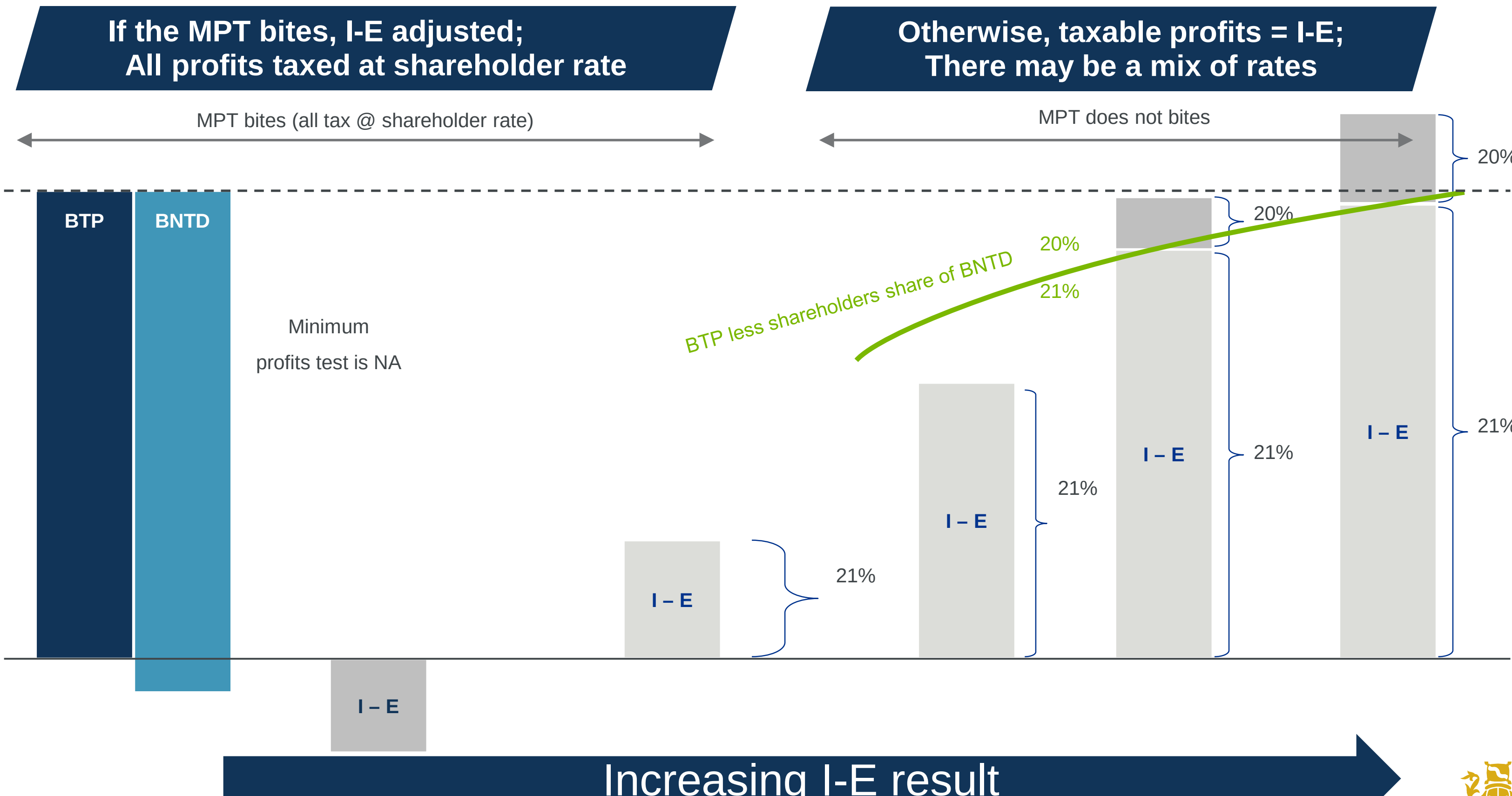
Implications of the new regime for modelling

- BLAGAB minimum profits test and tax rates



Implications of the new regime for modelling

- BLAGAB minimum profits test and tax rates



Implications of the new regime for modelling

- Insight into the possible simplifications

- Pre-2013 tax regime

XSI or XSE ?

- Traditionally considered to be the defining feature of a life company tax profile
- Sometimes assumptions made on long-term profile were hard to validate (particularly under stress)

- Post-2013 tax regime

Will minimum profits test ever bite?

- Less dependent on scenario
- Potential simplification that may be both more generic and more robust (i.e. model as mutual in both XSI and XSE scenarios)
- (but subject to a few caveats)

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Implications of the new regime for modelling

- Is the minimum profits test now irrelevant?

Example: BLAGAB unit-linked product		
Funds under management	1,000	**BLAGAB Dividends:** = 1,000 x 40% x 3% = **12 p.a.**
Equity backing	40%	
Dividend yield	3%	**BLAGAB trade profits:** AMC 10; Expenses (5); **5 p.a.**
AMC	1%	
Life co overheads & costs	0.5%	

Impact of trade profits on the I-E (the "minimum profits test")

- "Minimum profits" = BLAGAB trade profits less BLAGAB dividend income.
- Here minimum profits are negative: so test has no impact.
- I-E profit or loss determined in the same way as mutual.

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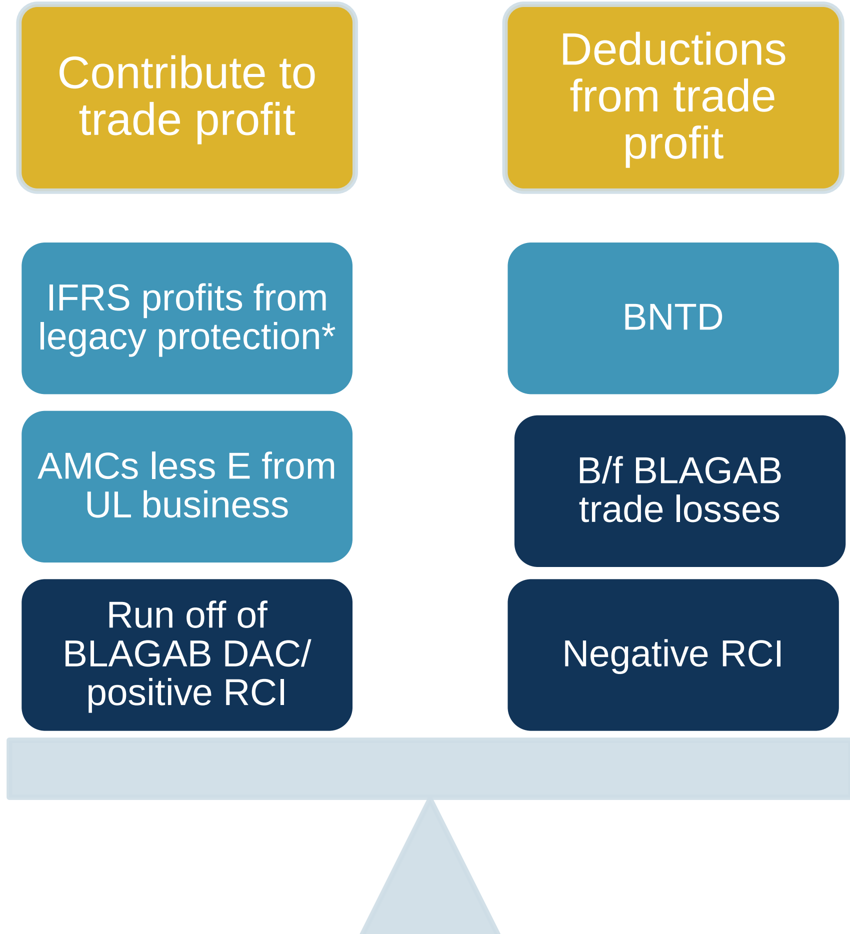
Implications of the new regime for modelling

- Will there ever be taxable BLAGAB trade profit again?



Items arising in future

Items reflected in deferred tax

Volatility in IFRS profits?

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Implications of the new regime for modelling

- BLAGAB cash tax profile

If minimum profits test never bites

- Some other complexity falls away:
  - Policyholder tax deduction and iteration
  - "Shareholders share" of dividends
  - c/f BLAGAB trade losses will have no impact on taxable I-E profit
- Taxable profit same as a mutual

Implications of 20% main rate

- Incremental rate of shareholder tax is nil.

Possible practical implications (subject to validation)

- Future cash tax for BLAGAB may comprise only:
  - "Mutual-basis" I-E tax
  - Possibly crystallisation of (part of) transitional DTL
  - Trade losses can be group relieved in year (but this is subject to restrictions)

Taxable I-E profits same as mutual

Tax rate same as mutual

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Implications of the new regime for modelling

- BLAGAB deferred tax profile

Is hurdle for recognising BLAGAB trade DTAs now too high?

- Circumstances where value is non-nil may be vanishingly small.
- Value at nil?

BLAGAB trade DTLs (a wrinkle)

- IAS 12 asymmetric - may need book DTL even if there will be no tax when the timing difference unwinds (can't anticipate future dividends to shelter reversal).
- However, incremental tax rate of nil if XSI.
- Does IAS 12 apply to EV and EC results? If not, consider releasing DTLs?

XSE and investment losses

- DTAs for XSE and investment losses should be focus. Model as for a mutual.

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Implications of the new regime for modelling

- What should inform the approach to tax modelling?

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Implications of the new regime for modelling

- Conclusions

- Tax ***profiles have changed***.
- ***Legislative simplification is only half the story*** – examine numbers to rationalise what further simplifications can be made.
- The defining point of a company's tax profile may now be whether ***treating BLAGAB like a mutual*** is a materially correct and prudent approximation.
- The ***effect of dividends on "minimum profits"*** may be more significant than the 20% main rate in driving simplification in modelling.
- Is there potential to push ***scenario modelling into BEL models***?
- Can ***validation be simplified***?
- Validation effort should be ***focused on non-tax assumptions*** supporting:
  - DTAs re XSE / investment losses and
  - Non-BLAGAB DTAs

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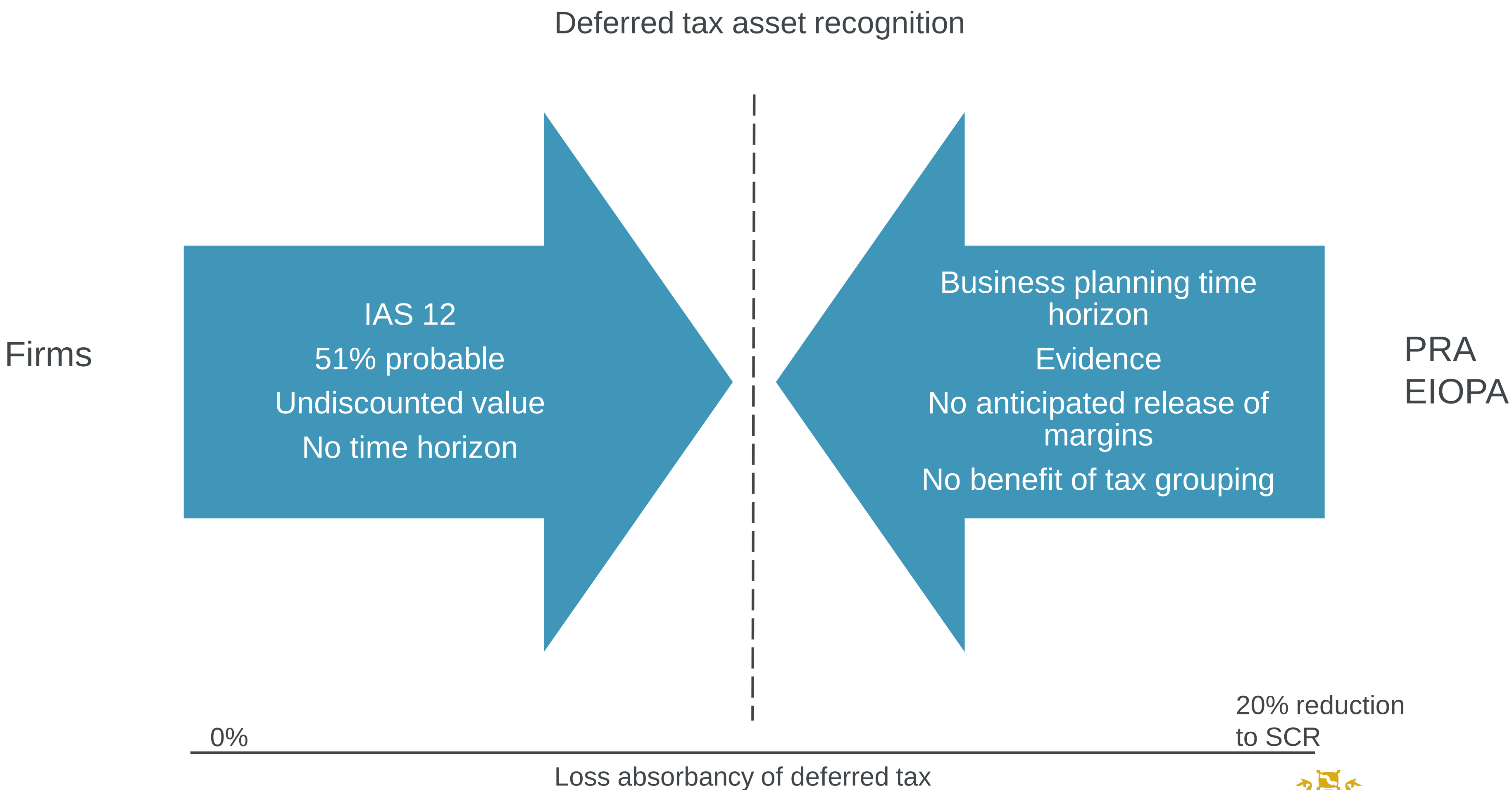
Tax in Solvency II

A Battlefield

11 December 2014

The Solvency II tax battlefield



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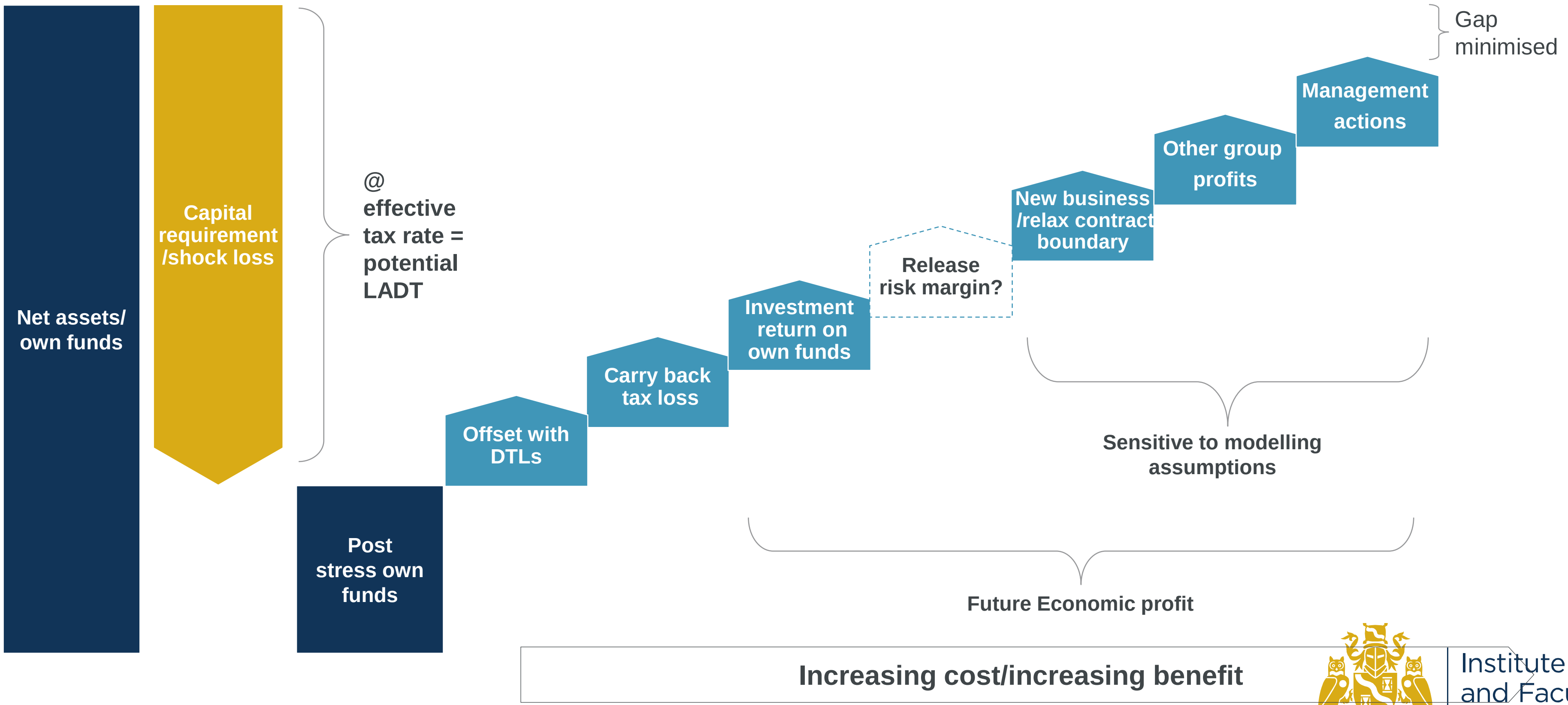
Tax in Solvency II

- Supporting the LADT: How might shock losses be recovered?

We have assisted firms develop practical and proportionate methodologies; understand the quality of their DTAs and address variation between jurisdictions.



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Tax in Solvency II

- What's the UK's PRA say about tax?

Scope of Supervisory Statement 2/14

- Tax on base balance sheet and tax in SCR calculation (LADT)
- Comments on credibility of profit projections

"may have a material impact on a firm's SII solvency position"

Concerns

- Inappropriate offsetting
- Double counting
- Lack of granularity
- Complexity

"Consider whether the results from such complex assumptions and inter-related calculations are likely to result in output of sufficient quality to justify the recognition of a tax effect"

Future profits

- New business profits can be anticipated.
- Transfer of tax losses to non-insurance entities is permitted.
- Projections of profit beyond the medium term permitted (provided there is "appropriate degree of certainty").
- Future profits form risk margin releases: not ruled out but an allowance for risk margin arising on future new business needs to be made (but will be sceptical due to complexity).
- For internal model firms, the shock loss is in the future and may not be instantaneous.
- Future management actions such as tax planning or changes in investment strategy can be included in profit projections used to support DTAs. Provided that such assumptions are consistent with the PRA's expectations, regulatory requirements and other constraints that may exist.

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The Solvency II tax battlefield

Defend DTA recognition

Proactively attack: Optimise how tax interacts with other items

Efficient and proportionate processes

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The Solvency II tax battlefield

Defend

DTAs

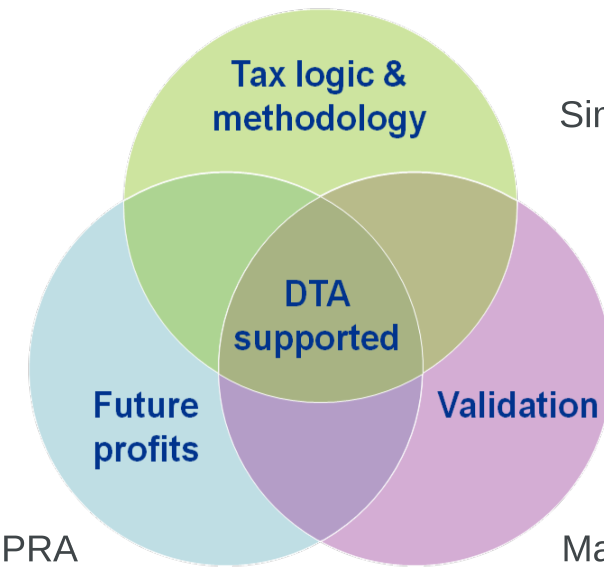
Don't gloss over I-E tax

Engage with PRA

SME expertise

Focus on drivers of profitability

Simplification



Transparency

Post stress modelling of IF and NB

Documentation

Insights for PRA

Management information

Life and GI tax surveys

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The Solvency II tax battlefield

- Attack and Optimism

Items impacted by tax (for UK I-E business)

- Calculation of Risk margin
- Loss absorbency of technical provisions
- Best estimate liabilities

Other items

- Tier 1 and Tier 3 capital
- Diversification

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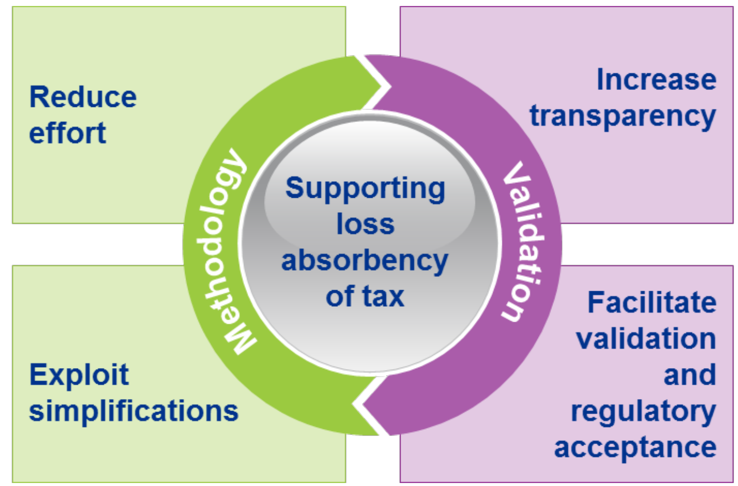
The Solvency II tax battlefield

- Efficient and Proportionate

- Tight reporting timeframe
- Extract relevant MI
- Embed tax in other models
- Consider ease of validation
- Model I-E business on new simplified bases



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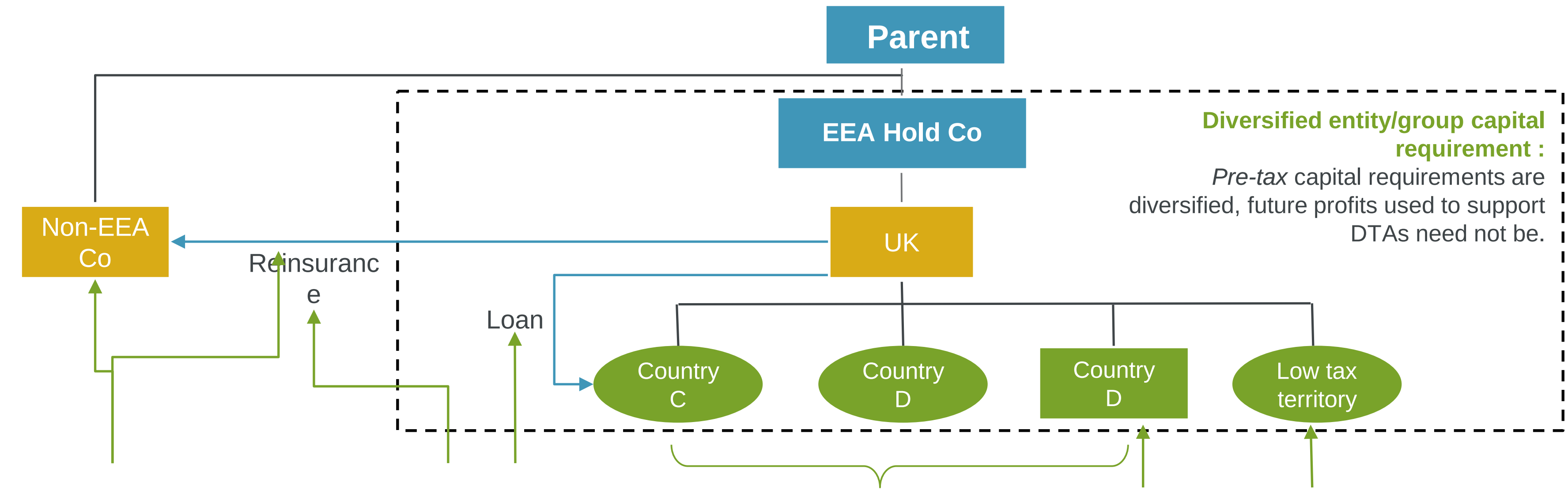
Tax in Solvency II

- Group level tax considerations

Key points will be to consider the difference between the entity and group positions; the impact of intergroup structuring arrangements and exploit developments in modelling to support DTAs



Reinsurance:
Will shock losses and the future profits required to support DTAs emerge in the same jurisdiction? What are the tax rates?

Intra-group transactions:
If there is counterparty risk or complex instruments between entities, the tax impact of these under both normal and stressed conditions needs particular consideration. A default by one party may or may not give a tax deductible loss for the other.

Diverse local tax regimes:
Tax rules vary in each territory. Key points include rules which limit loss carry forwards, timing of loss crystallisation, assets or liabilities on historic cost for tax purposes, tax grouping and tax exempt entities.

Subsidiaries /branches:
The tax position of subsidiaries and branches may differ.

Low tax jurisdictions:
While it is an advantage for profits to emerge in low tax jurisdictions, the impact of tax on required capital may erode some of the benefit.

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Tax in Solvency II

- Questions to ask

What is the % decrease to the SCR due to LADT?
How does that compare to your local tax rate?

If it is low,
Is you capital requirement too high?
Are you at a disadvantage relative to your peers?

If it is high,
What evidence do you have to support recoverability?
How have you validated it?

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Update on topical tax matters

Mike Allen

11 December 2014

Topics

– Pensions changes
– FCA thematic reviews
– Tax transparent funds
– New UK GAAP
– BEPS
– Exchange of information
– Tax rates

Pension changes

- Existing regime requires annuity purchase by age 75, punitive tax for withdrawals unless very small pot, restrictive drawdown rules
- From 27 March 2014 limits on triviality and small pots lifted and capped and flexible drawdown rules relaxed
- From April 2015 no compulsion - can fully withdraw, purchase annuity or drawdown over time; all taxed at marginal rate
- Can inherit a pension fund; tax free if death before age 75, otherwise taxed at 45% [may reduce to marginal rate]
- 'At retirement' guidance to be given (details still to be resolved)

Pension changes impact

- Overhaul of operating model required, immediate system and literature changes
- Structural changes to the market likely with winners and losers. Shift from insurers to fund managers?
- Transfer of DB schemes to DC to allow access?
- Opportunities to develop new products – variable annuities, combined income and care products?
- Impact on VIF – early retirements or pots held for longer?

FCA thematic reviews

- Budget and FCA reviews challenge life company business models
- Consistent with broader Government agenda to increase savings, improve advice quality, simplify products, improve product value and empower customers
- FCA fundamental focus on TCF by challenging culture, monitoring and value for money.
- Question of how far companies should go to benefit policyholders (e.g. FII GLO application)
- Legacy product review will be challenging for insurers

Asset pooling using tax transparent funds

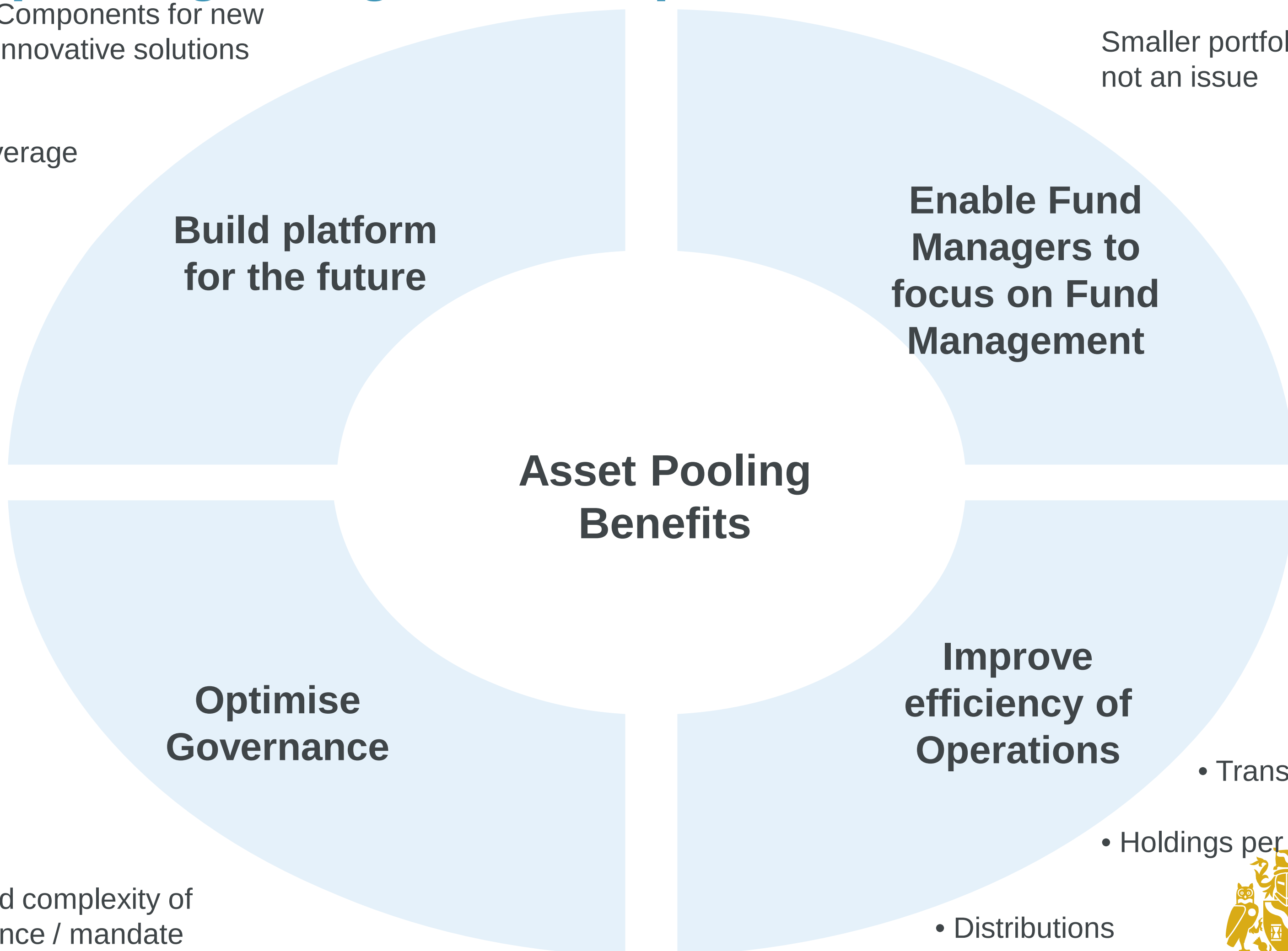
Components for new innovative solutions

Retail can leverage AuM better

Tax efficiency

Smaller portfolios not an issue

Pooled vehicle separate from distribution structures



Reduced volumes for size of Business:

- Portfolios
- Custody accounts
- Transactions
- Holdings per asset line
- Distributions

Rationalisation of ManCo's

Reduced complexity of compliance / mandate monitoring

New UK GAAP

- New UK GAAP from 2015
- Choice of FRS101 (IFRS lite) or FRS102
- If FRS102, insurers apply FRS103 (ABI SORP replacement)
- Tax consequences if derivatives, hedging, purchased goodwill, functional currency change
- Remember accounts are now starting point for life computation

Base Erosion and Profits Shifting (BEPS)

– OECD initiative, driven by G20
– Addresses the perceived ability of multinationals to decide where, and indeed whether, they pay tax on their profits
– 15 Action points with ambitious timetable and short consultations
– Of concern for insurers is <u>people v capital</u> debate, particularly in relation to intra-group reinsurance
– Action point on Permanent Establishment status may impact
– Country by country reporting and common transfer pricing documents proposed

Exchange of information

– Various initiatives – FATCA, CDOT, AEOI, CbCR, EUSD
– Insurance products with savings component in scope for all regimes
– Significant data management requirements
– Regimes differ - who is reportable, definition of financial institution

Tax rates

– Enacted rates: 21% from 1 April 2014 and 20% from 1 April 2015 so shortly policyholder and shareholder rates will be the same.

– However, Scottish income tax rate (from 1 April 2016) could cause serious problems for employers and annuity payers.

– Also Scottish Land Transaction Tax.

Disclaimer

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