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Institute & Faculty of Actuaries

Life Office Taxation Course

Disclaimer

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Introduction

Gavin Coates

Programme

9.30 am	Course Introduction	Gavin Coates	1.30 pm	'Shareholder Tax'	Jeanette Cook
9.40 am	Life Office Tax Overview	Steve Jones	2.20 pm	Case Study Parts 3 & 4	
10.15 pm	'I-E' Tax	Jeanette Cook	3.15 pm	Review Case Study 3 & 4	
11.00 am	MORNING TEA		3.30 pm	AFTERNOON TEA	
11.15 am	Apportionment	Clayton Balkind	3.45 pm	Tax Modelling & Planning	Trevor Fannin
11.45 am	Case Study Parts 1 & 2		4.20 pm	Other issues	Laura Kochanski
12.40 pm	LUNCH		4.50 pm	Conclusions and Questions	
			5.00 pm	Close	

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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

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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

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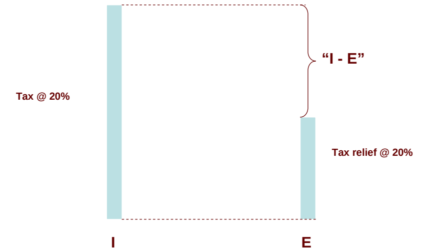
Simplistic tax model: Mutual



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

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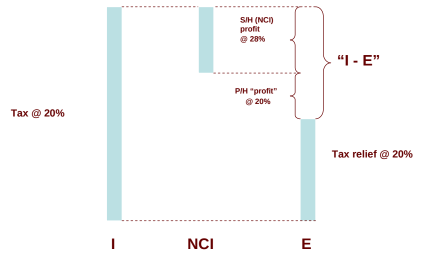
Simplistic tax model: Proprietary Net (or Excess I) situation



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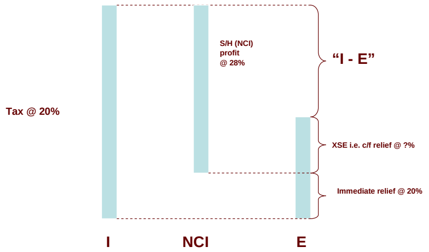
Simplistic tax model: Proprietary Gross (or Excess E) situation



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
- But an office's tax calculations are done at global level
- And the 'reasonable but simplistic' calculations only add up to the overall tax bill in special situations (e.g. when all business written falls in the same tax category, there are no taxable losses available, …)
- Understanding when the 'reasonable but simplistic' calculations don't add up is important!

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% x 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 XSE 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

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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 XSE 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: tax = 20% x (I - E) + (28% - 20%) / (1 - 20%) x max (0, 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

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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 XSE 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

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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 XSE 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

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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 XSE 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

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Case study: conclusions

- The tax rules can put protection-only companies at a competitive disadvantage as no credit is given for XSE
- To get value from the XSE, 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 XSE, you need to carefully monitor the volume sold

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Complications: I

- All returns (coupons, realised & unrealised gains) from gilts & corporate bonds 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)
- Need to estimate time before gains are realised
- … and choose an appropriate discount rate
- Should we give credit for losses?

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Complications: E

- Maintenance & valuation expenses flow immediately into E
- … but acquisition expenses (initial & renewal commissions, underwriting costs, salesforce support costs) are spread over 7 years
- At a discount rate of 8%, present value of acquisition E tax relief is worth around 14.5% rather than 18%
- Not always allowed to count deferred E or XSE for valuation purposes
- Valuation should be cautious if usage isn't certain

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Complications: NCI

- Franked investment income doesn't count towards NCI profit (and it doesn't appear in the I calculation either)
- Losses are carried forward to be offset against the office's next NCI profit
- Like carried forward E, not always allowed to count NCI losses for valuation purposes
- & again, valuation should be cautious if usage isn't certain - which it may very well not be after a 1-in-200 ICA scenario

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Some practical investigations

- During business plan - build a reconciliation from the calculated tax bill to the tax from simplistic model (pretty difficult). Scenario test to:
  - ensure reconciliation and plan tax model are working
  - understand when these differences work for or against you
  - investigate scope for mitigation
- Analysis of statutory surplus, or of change in EV - understand the tax bucket.
  - more difficult as plan tax model & plan revenue are often simplified (although still pretty complex)
  - but will show weaknesses of any such simplifications
- The control cycle in action!

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Sample output of these investigations

Simple expected tax bill (18% x (I – E) + 10% x NCI + 28% x "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 … XSE 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
Actual tax bill	(127)

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Summary

- Why worry about tax?
- A simplistic tax model
- What tax formula should I use in my profit-testing model?
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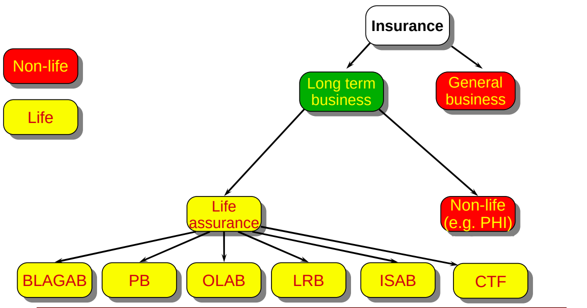
The “I-E” Calculation

Jeanette Cook

Categories of insurance business



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Definitions

“the I minus E basis” (s431(2) ICTA1988) revision in FA07

> **“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 Case I of Schedule D”**

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

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

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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)**

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"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 policy holders	
I - E	

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"Proof" of I-E scope

	Shareholders' return £	Policy holders' 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 policy holders		470
I - E		

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“Proof” of I-E scope

	Shareholders' return £	Policy holders' 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 policy holders		470	
I - E			500

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Simple I minus E computation

	£	£
BLAGAB Investment Income		
Sch A net of expenses	x	
Income from loan relationships	x	
Capital movements on loan relationships	x	
Interest Payable	(x)	
		x
Sch D case III (other)		x
Sch D case V		x
Sch D case VI		x
		x
BLAGAB Chargeable gains		x
Total BLAGAB income and chargeable gains		x
GRB (PB/OLAB/LRB/ISAB) Case VI profit		*x*
Less: expenses of management		(x)
capital allowances		(x)
Taxable I minus E result		x

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Example I minus E computation

	£	£
BLAGAB Investment Income		
Sch A net of expenses	x	
Income from loan relationships	x	
Capital movements on loan relationships	x	
Interest Payable	(x)	
		x
Sch D case III (other)		**x**
Sch D case V		**x**
Sch D case VI		x
		x
BLAGAB Chargeable gains		x
Total BLAGAB income and chargeable gains		x
Gross Roll up (PB/ISAB/OLAB/LRB/CTF) Case VI profit		*x*
Less: expenses of management		(x)
capital allowances		(x)
Taxable I minus E result		x

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BLAGAB Investment Income

- **Schedule A** - **UK land and REIT distributions**
- **Schedule D Case III** - **profits & gains from loan relationships**
- **Schedule D Case V** - **income arising from overseas possessions**

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Example I minus E computation

	£	£
BLAGAB Investment Income		
Sch A net of expenses	x	
Income from loan relationships	x	
Capital movements on loan relationships	x	
Interest Payable	(x)	
		x
Sch D case III (other)		x
Sch D case V		x
Sch D case VI		x
		x
BLAGAB Chargeable gains		x
Total BLAGAB income and chargeable gains		x
Gross Roll up (PB/ISAB/OLAB/LRB/CTF) Case VI profit		*x*
Less: expenses of management		(x)
capital allowances		(x)
Taxable I minus E result		x

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BLAGAB sundry income

	£
Life reinsurance deemed income	X
Section 85 FA 1989 income	
e.g.Underwriting commission	X
Stock lending fees	X
Schedule D Case VI	X

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Example I minus E computation

	£	£
BLAGAB Investment Income		
Sch A net of expenses	x	
Income from loan relationships	x	
Capital movements on loan relationships	x	
Interest Payable	(x)	
		x
Sch D case III (other)		x
Sch D case V		x
Sch D case VI		x
		x
BLAGAB Chargeable gains		x
Total BLAGAB income and chargeable gains		x
Gross Roll up (PB/ISAB/OLAB/LRB/CTF) Case VI profit		*x*
Less: expenses of management		(x)
capital allowances		(x)
Taxable I minus E result		x

BLAGAB chargeable gains

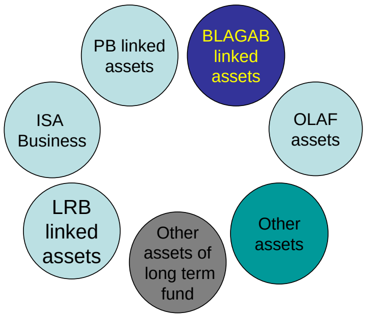
Chargeable gains on disposals of investments	X
Section 212 TCGA 1992 gains on deemed disposals of Unit Trusts, OEICs and interests in offshore funds	X
	X

Annual deemed disposal of UTs / OEICs

Section 212 TCGA 1992 states

- "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 referable to BLAGAB or would be treated as part of capital redemption business
- Gains arising are spread forward over 7 years
- Losses can be carried back for 2 years

Chargeable gains ‘boxes’ (s440 TGCA)



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Simple I minus E computation

	£	£
BLAGAB Investment Income		
Sch A net of expenses	x	
Income from loan relationships	x	
Capital movements on loan relationships	x	
Interest Payable	(x)	
		x
Sch D case III (other)		x
Sch D case V		x
Sch D case VI		x
		x
BLAGAB Chargeable gains		x
Total BLAGAB income and chargeable gains		x
GRUB (PB/OLAB/LRB/ISAB) Case VI profit		**x**
Less: expenses of management		**(x)**
capital allowances		(x)
Taxable I minus E result		x

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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.**

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Acquisition expenses

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
- other expenses of management disbursed partly for acquisition of business

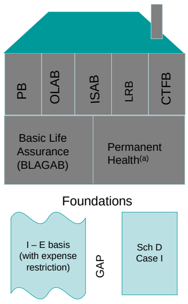
Spreading of acquisition expenses

- 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

	00	01	02	03	04	05	06	07	08	09
2000	1/7	1/7	1/7	1/7	1/7	1/7	1/7			
2001		1/7	1/7	1/7	1/7	1/7	1/7	1/7		
2002			1/7	1/7	1/7	1/7	1/7	1/7	1/7	
2003				1/7	1/7	1/7	1/7	1/7	1/7	1/7
Total	X	X	X	X	X	X	X	X	X	X

The Life Assurance Tax House (pre FA07)



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 Sch D Case I basis separately from the other insurance business shown

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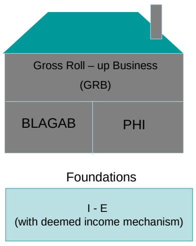
The Life Assurance Tax House (post FA07)



- 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 NCI result less BLAGLAB UK dividends
- Proper definition of “I - E basis” for first time

(a) Permanent health insurance business is taxed on a Sch D Case I basis separately from the other insurance business shown

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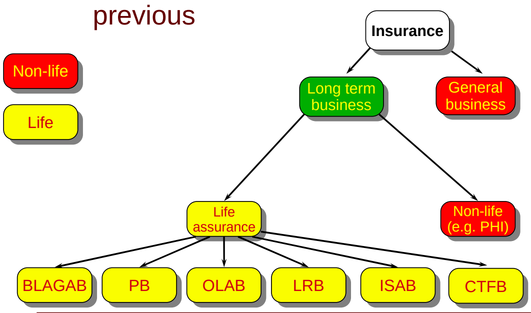
Apportionment

Clayton Balkind

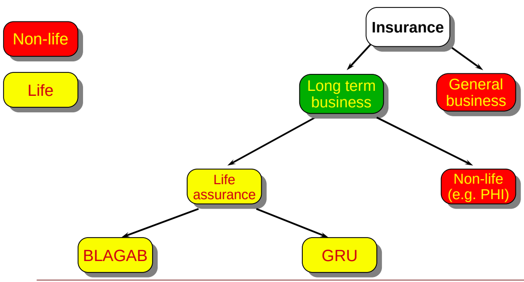
Allocation of Investment Income & Gains

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

Categories of insurance business - previous



Categories of insurance business - Accounting periods beginning on or after 1 January 2007



Income & Gains Summary (Non-Profit Office)

	FII	Investment Income	Realised Gains	Unrealised Gains
BLAGAB	Exclude	All	Chargeable	-
GRU	Include net	All	All	All
PHI	Exclude	All	All	All

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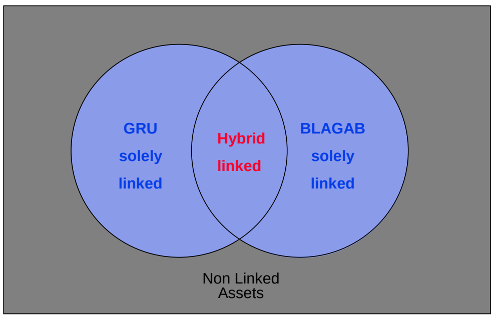
Allocation for BLAGAB purposes

Assets of long term fund



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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"

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Allocation of income and gains

	BLAGAB	GRU
Solely Linked	Actual	Actual
Hybrid Linked	Proportion	Proportion
Other assets	Proportion	Proportion
Total	XXX	XXX

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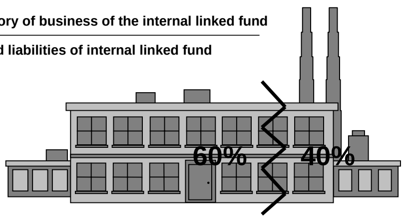
Hybrid Linked Assets

How to allocate

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

$$\frac{\textbf{Liabilities of category of business of the internal linked fund}}{\textbf{Total linked liabilities of internal linked fund}}$$



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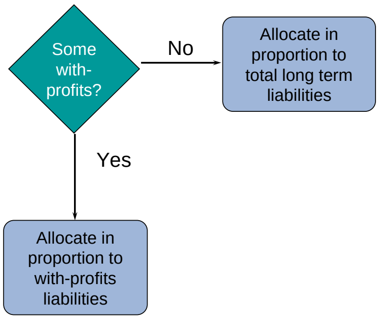
Allocation of free asset amount



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Fraction (s432A ICTA 1988)

	BLAGAB	GRU	Total
	£	£	£
Mean liabilities	X	X	X
Less: **mean linked assets**	(X)	(X)	(X)
add: mean Free Asset amount	X	X	X
	A	B	C
Percentage	A/C	B/C	100%

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Allocation for Case VI computations

s432A vs s432B ICTA 1988

Why not use s432A calculation?

- s432A : an allocation of entire investment income and chargeable gains
- s432B : an allocation of investment return "brought into account"

Therefore ignore Free Asset Amount

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Investment Return

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 realised or not) of linked and non-linked assets included in Form 40 (lines 13&14)

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With Profit Case VI 'Needs' Basis

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

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Fraction (s432 C&D ICTA 1988) Non-profit business

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

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GRU Case VI computation

			£
Liability brought forward			X
Premiums			X
Investment return (†)			X
			X
Claims including annuities	X		
less bonuses paid in anticipation	(X)		
		X	
Expenses		X	
Closing liabilities (exc bonuses)		X	
			(X)
Pre-tax surplus			X
Bonuses declared			(X)
Disallowed expenses			X
Policyholders' overseas tax			(X)
Schedule D Case VI profit			**X**

(†) dividend income included net of tax credits

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Uses of the allocations

	BLAGAB	GRU	PHI
Section 432A allocations ("I-E")			
UK dividends (net)	✓	×	×
UFII	✓	×	✓
Sundry income	✓	×	✓
Chargeable gains	✓	×	✓
Unrealised Gains	×	×	✓
Section 432B allocations ("Case VI")			
Investment return	×	✓	×

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Case Study Parts 1 & 2

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Notional Case I

Jeanette Cook

Why do we need an NCI computation?

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

- Per HMRC Manual a Case I basis of computation maybe needed to calculate:
  - the policyholder's share of the relevant profits
  - the NCI restriction of the relief for expenses of management (minimum profit test)
- Profits are taxable at 30% and losses are available for group relief

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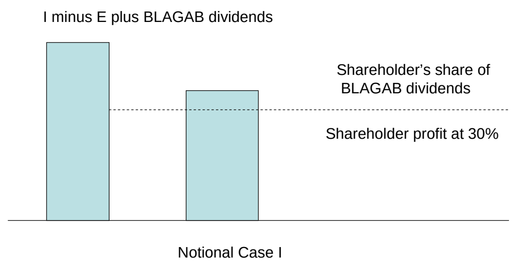
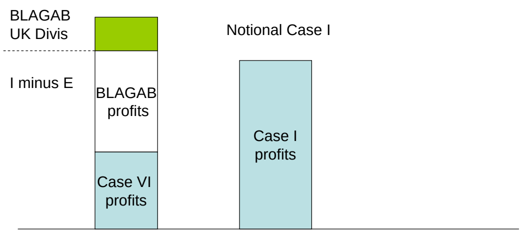
Minimum Profits test



How is the NCI profit calculated?

	£	£
Surplus arising in the year		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 NCI Profit		X
Add: tax provision per Form 40	X	
Less: policyholders' tax	(X)	
Shareholders' tax		X
Gross NCI profit		**X**

Ideal world – Step 1



Ideal world – Step 2

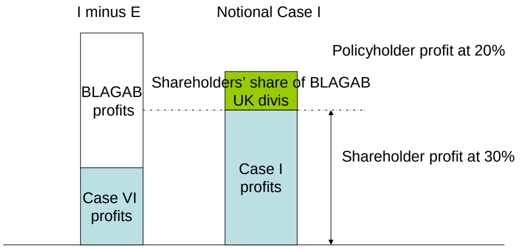


Illustration of old rules

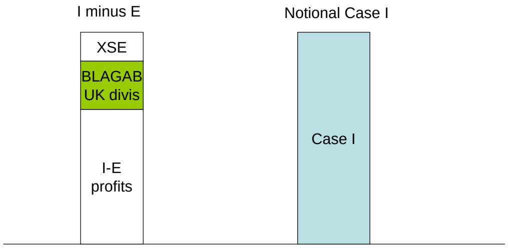


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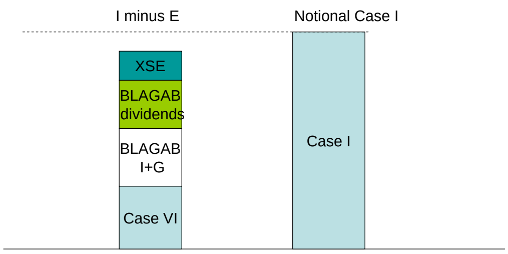
Illustration of old rules



If XSE fully restricted and a 'gap' still existed then there was a potential for HMRC to impose an Actual Case I assessment.
BLAGAB dividends then taxed, XSE lost, DAC & Case VI losses only available if revert back to I minus E.

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When was the 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 Case I principles
- Temporarily
  - Use an avoidance scheme
  - Large release of surplus to shareholders
  - Significant change in the nature of the business written

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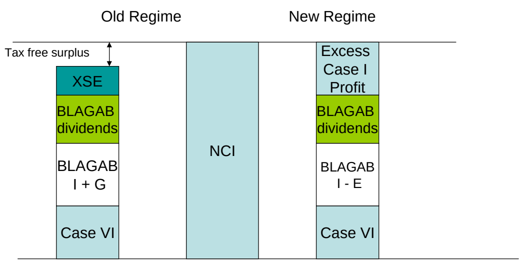
Revision to the Crown Option in FA 07



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Simple example: Expense restriction

BLAGAB income & gains	100
BLAGAB expenses	50
UK Dividends	20
Shareholders share of dividends	50%
NCI profits	80

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

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

Question 3: what is the amount of profit chargeable at 28%

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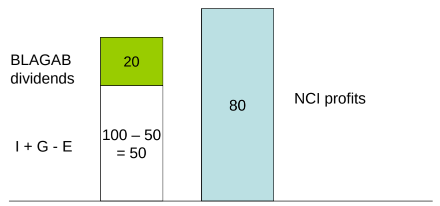
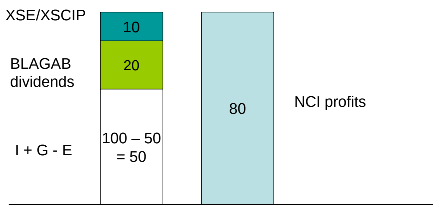
Answer Q1 & Q2



Answer Q1 & Q2



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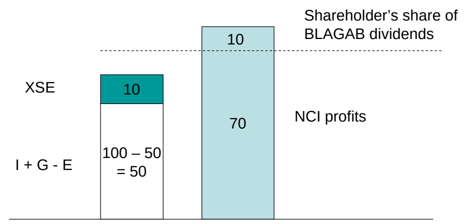
Answer to Q3



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Simple example: Expense restriction (2)

BLAGAB income & gains	100
BLAGAB expenses	50
UK Dividends	20
Shareholder proportion of dividends	20%
NCI profits	130

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

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

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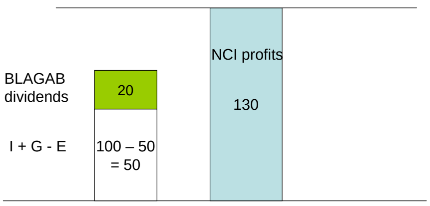
Simple example: Expense restriction (2)



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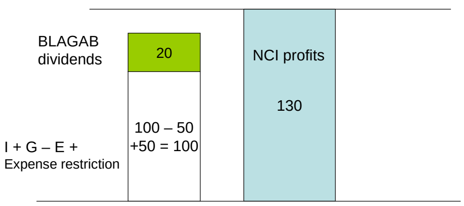
Simple example: Expense restriction (2)



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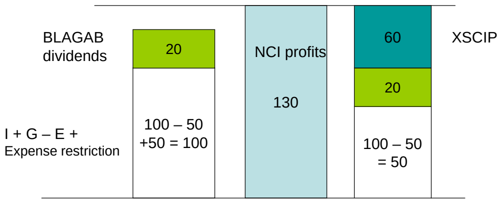
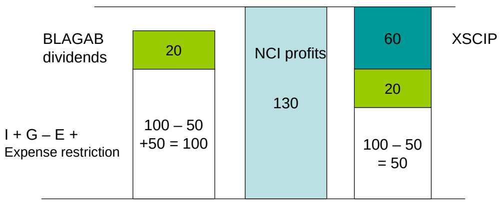
Simple example: Expense restriction (2)



Simple example: Expense restriction (2)



Old regime	New regime
XSE carried forward = 50	XSCIP carried forward = 60

Use of NCI 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

Losses available for surrender (s434A)

NCI loss for the period concerned	x	
Less: non trading deficits on BLAGAB loan relationships	(x)	
[*losses on overseas life assurance business*		*(x)*]
Loss available for surrender		x

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Consequences of utilising NC1 losses

Where an NC1 loss is either surrendered as group relief or used under section 393A ICTA 1988, then by virtue of section 434A (2)(b) ICTA 1988:

- Where the NC1 loss utilised exceeds the case VI loss, the case VI loss is reduced (to nil) and BLAGAB management expenses are reduced by the loss utilised
- Where case VI loss exceeds the NC1 loss utilised, each of the case VI losses is proportionately reduced, by the fraction of the case 1 loss, of which the category case VI is the numerator and the total case VI is the denominator

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Use of NCI losses carried forward

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

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Calculation of tax charge

Calculation of tax charge

Taxable I minus E result & Case VI result		x
Shareholders' share at full CT rate	x @ 30%	x
Policyholders' share of profits taxable at lower rate	x @ 20%	x
Total tax charge		x

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Pension Case VI computation

Case VI Computations

- Follows principles of Case I computation

Profit before tax	X
add back disallowables	X
deduct capital allowances	(X)
Case I Profit	X

- 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)

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Pension Case VI computation

			£
Opening liabilities			X
Premiums			X
Investment return			X
			X
Claims including annuities	X		
less bonuses paid in anticipation	(X)		
		X	
Expenses		X	
Closing liabilities (exc bonuses)		X	
			(X)
Pre-tax surplus			X
Bonuses declared			(X)
Disallowed expenses			X
Policy holders' overseas tax			(X)
Schedule D Case VI profit			**X**

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Case VI losses

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

Post FA 07 the case VI 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 case VI losses can be used against all GRU business profits, i.e. ISAB losses brought forward can be used against all GRU profits

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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, 432D, 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

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Simple example: PB loss streaming FA07

BLAGAB income & gains	110
BLAGAB expenses	50
Case VI profit	50
UK Dividends	20
Shareholder proportion of dividends	50%
NCI 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 XSCI profit carried forward under FA 07?

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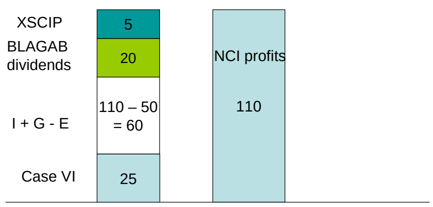
Answer



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Institute and Faculty of Actuaries

Case Study Parts 3 & 4

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Tax Modelling and Planning

Trevor Fannin

Tax Modelling and Planning

Agenda

- ICA and other stochastic modelling
- Planning
- Treating policyholders fairly

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Tax Modelling

Potential areas requiring tax modelling
- FSA regulatory valuation
- FSA realistic valuation
- ICA
- International Financial Reporting Standards
- Embedded value
- European Embedded Value
- FRS 27
- US GAAP
- Internal projections and FCRs

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Modelling limitations

Typical shortcomings of embedded value models
- BLAGAB expenses assumed always relieved
- Losses not assumed to occur
- BLAGAB capital gains simplistically modelled
- UK dividend income not identified
- Brought forward tax assets modelled manually
- May not recognise special tax issues in the projection period
- Unit fund complications may not be modelled

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Limitations in stochastic modelling

Tax issues in stochastic modelling
- Manual adjustments are not practical
- Economic scenarios generate gains **and losses**
- BLAGAB capital gains simplistically modelled
- Tax modelling in projection routines rarely allows for deferral of tax relief on losses
- Losses typically complicate the tax calculation (eg interaction between the relief of Case VI losses and XSE)

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Asymmetry and stress conditions

- Some tax assets are effectively "call options" so require stochastic valuation!!
- Modelling needs to allow for immediate taxation of profits and deferred / nil relief for losses
- Stochastic modelling will include extreme scenarios – especially in stressed and ICA calculations. Taxation may require further thought for these calculations

Asymmetry and stress conditions

Examples of extreme scenarios

Scenario	Equity	Property	Gilt yields	Credit spreads
1	(45)%	2%	(1.5)%	1.15%
2	(26)%	(12)%	(0.6)%	0.9%
3	(1)%	(28)%	(1.1)%	0.3%

Note that the above examples are only year 1 effects

Frictional Cost – Double taxation

Example of double taxation

Pension scheme has a choice of investing £1m in a 1 year bond or in a shell company whose capital is the same £1m of 1 year bond

Investment return on the 1 year bond is 5% over the year

Return obtained by the pension scheme from investment:

Directly in the bond

Gross return = 5% of £1m	= £50,000
Tax payable	= nil
Net return	= £50,000

Indirect investment using the company

Gross return in company = 5% of £1m	= £50,000
Tax on profit @ 30% of £50,000	= £15,000
Net profits of company	= £35,000
Distribution to pension scheme	= £35,000
Recoverable tax credit	= Nil
Double taxation	= £15,000

Double taxation effects depend on:

- The type of assets held as capital
- The assumed ultimate holders of the company

New Business

New business cash flows impact significantly on taxation of a company.

Example	Year				
	1	2	3	4	5
Existing business profit	100	90	80	70	60
New business profit	(40)	10	10	10	10
Total profit	60	100	90	80	70
I-E	65	65	65	65	65

What adjustment should be made for unrelieved expenses?
How should any adjustment be allocated between existing and new business?
What value is placed on the year 1 new business tax loss?

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Value of tax assets

Tax assets include the following

- Unrealised losses in unit funds
- Realised losses in unit funds which may have been relieved at company level
- Unrelieved expenses
- Case IV losses
- NC1 losses
- Tax relief due to with-profits funds

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.
Conditions that give value to the assets can be very complex

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Tax planning

Objectives for actuaries

- Forward looking
- Use knowledge of financial drivers in the company
- 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

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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
- Anticipate impact arising from the tax consultation document

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Treating policyholders fairly

Examples

- Unit fund deferred tax provisions
- Allocation of tax in accordance with Part VII or Sch 2C schemes
- Allocating tax to with-profits business

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Treating policyholders fairly

Conduct of business rules 6.12.72AR and 6.12.72BG

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

If a firm carries on insurance business outside its with-profits fund , it should assess the extent to which the corporation tax liability arising in respect of that business has been affected by the insurance business within the with-profits fund . If the insurance business within the with-profits fund has reduced the corporation tax liability that would have otherwise arisen in respect of that other business, the firm's governing body should consider whether any unfairness results. In particular, if the firm has taken an action, or a series of actions, that were intended to cause a material part of the tax charged to the with-profits fund to emerge as a contribution to the profit of the firm, it may be unfair if no reduction is made to the amount so charged.

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Tax Modelling and Planning

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Current Developments

Laura Kochanski

Agenda

- Overview on the life tax consultation
- Progress of consultation in the Finance Bill 2007
- Other topics
  - change in tax rate
  - VAT
  - EU claims

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Life tax consultation process

Areas consulted on

- Amalgamation of categories of business
  - 6 into 1 or 5 into 1
- Part VII transfers
  - desire to simplify legislation
- Apportionment
  - desire to tax only 100% of income
- Losses and Group Issues
  - Structural assets
- Crown Option
- Friendly Societies

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Life tax changes

Pre-budget announcements 2 December 2004

- Regulatory changes
- Anti-avoidance: transfers of business
- Recognition of revenue accounts
- Changes to apportionment and measure of shareholder profits
  - Loss of pensions exemption
  - Taxation at 30 percent
- Consulted on in advance
- Problem for planned transfers
- HMRC have long had a problem with separate funds
- Surprise changes
- Major and controversial changes
- Double taxation
- Flawed legislation

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Life changed – 29 September 2005

- Retrospective legislation
- 1. Taxation of investment reserve in non-profit funds – F14 line 51
- 2. Surpluses prior to demutualisation
- Effective for 2005
- Whole of investment reserve could be taxed in 2005 at 30%
- No reduction for capital support
- Actual Case 1 assessment
- Tax charge where mutual surplus used to fund p\h bonuses and s\h transfers post demutualisation

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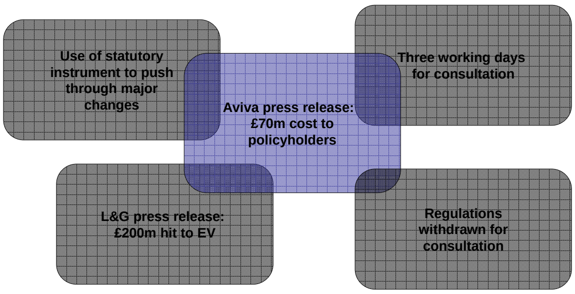
Industry response in autumn 2005

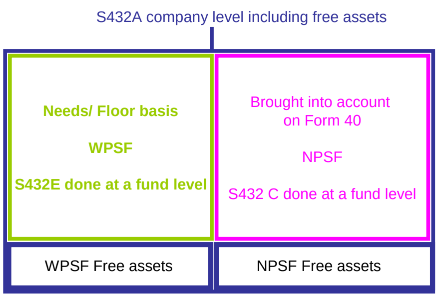


Where are we now?

Progress
- Crown Option
- 5 into 1
- Structural assets?

Outstanding Areas
- Part VII
- TAAR
- Finance-arrangement-funded transfers
- Apportionment

Current Apportionment Rules



What are the options?

Approach 1: Apply s432A across whole company for all purposes
Doesn't reflect Needs/Floor position for WP GRB

Approach 2: Apply s432A on a fund by fund basis
Still doesn't reflect Needs/Floor position for WP GRB

Approach 3: Apply s432C for NPSF for all purposes
Apply s432E for WPSF for all purposes
Is s432E appropriate for BLAGAB I minus E?

Approach 4: Scale up or down to reach 100%
Neither BLAGAB not GRB has "reasonable" allocation

Possible compromise position of option 3.5

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Option 3.5

- No longer requires 100%
- Allocate each sub-fund separately
- Use s432C for NPSF (BLAGAB & GRB)
- Use s432C for BLAGAB and s432E for GRB for WPSF

Potential issues
- Still potentially results in taxable income exceeding 100%
- Identify income, mark to market movement at fund level?
- Capital boxes must be maintained at fund level?

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What are implications?

Use of Case VI (or GRB) losses
- PB losses brought forward are streamed
- other losses may become more valuable

Apportionment
- watch this space

Crown Option
- removes uncertainty of Actual Case I assessment
- I minus E tax attributes carried forward

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Other considerations for 2007

Change in the corporation tax rate to 28%
- substantially enacted?

VAT
- recover VAT paid on certain outsourced activities
- EC consultation including zero rating for insurance

EU claims
- reclaim with-holding tax on cross border dividends
- treat overseas dividends the same as UK dividends

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