UNIT 5 — UK TAX ENVIRONMENT

Syllabus objective

(e) Describe, in terms of the following, the regulatory environment for UK life insurance companies, and how this environment affects the way these companies carry out their business in practice, including the related analyses and investigations:

1. The taxation of the UK business of life insurance companies and the effect of taxation on the benefits and premiums paid under UK life insurance contracts.

1 Taxation

Background

The after tax investment return earned by a holder of a life assurance policy can be considered as the result of tax effects at each of the following stages:

- Tax payable or recoverable on the payment of each premium.
- Tax payable or recoverable by the life company on receipt of each premium.
- Tax payable or recoverable by the life company on receipt of income and gains on the assets in which the premiums are invested.
- Tax payable or recoverable by the life company on the payment of policy benefits.
- Tax payable or recoverable by the policyholder on the payment of policy benefits.

If tax is considered in this way, the taxation implications of investing via a life insurance company can be compared with all other methods of investing (e.g. direct investment in government bonds or company shares, investment in a bank deposit, investment in an ISA or an OEIC etc) if the tax effects of the alternatives are considered in a consistent way.

Different countries adopt different approaches to taxation of savings but the overall intention is normally to ensure that there is taxation of the investment gain at some stage. Examples would be:

- Premiums payable out of gross personal earnings, tax free roll up of invested money, tax on all policy proceeds at personal tax rates. UK pension policies are an example of this approach.
- Premiums payable out of net income, taxation of the investment return on invested money, no tax payable on policy proceeds. Bank deposits and UK qualifying life assurance policies such as mortgage endowments are an example of this type of approach.

Incentives are often used to a limited extent to encourage people to invest in order to achieve some government social objective. In the UK examples would be:

- Parts of the pension regime whereby the lump sum at retirement is available tax free (the subsequent regular pension payments are fully taxed).

- ISAs, which are similar to “qualifying“ life assurance policies (see below) but there is no tax of the investment return on invested money.

This Unit describes the detail of how the above tax concepts are applied in the UK.

1.1 Tax as regards the policyholder

For the purposes of considering the tax payable by the policyholder, it is convenient to divide the contracts issued by UK life insurance companies into four groups: life assurance contracts, general annuity contracts, pension contracts and permanent health insurance (PHI) contracts. Note that the term “life assurance contracts” can be used to mean all business written by life insurance companies, but is also used to refer to the subset of those contracts that are not pensions, general annuity or PHI contracts. For the rest of this Unit, the term “life assurance contracts” will refer to just this subset of contracts.

PHI contracts are only covered in Unit 2 (UK specific products) of Subject SA2 and are outside the scope of this Subject for tax purposes. Therefore, they will not feature in this Unit.

There is a further type of business — capital redemption contracts — transacted by UK life insurance companies, but the volume of business is now so small that it, too, will not be covered in this Subject.

1.1.1 Life assurance contracts

1.1.1.1 Qualifying status

Qualifying in this context means whether the benefits payable under a life assurance contract generally qualify for not being taxed in the hands of the policyholder.

Apart from some minor contracts, these contracts can be divided into those that are “qualifying” and those that are “non-qualifying”. Tax payable on benefits depends on the qualifying status of a contract.

To be qualifying, a contract must satisfy certain rules. These rules, which depend on the type of contract, cover such things as the following:

- the term of the contract
- the premium paying term
- the frequency of payment of premiums
- the relationship between the premiums payable in different 12 month periods
- the benefit on death in relation to the total premiums payable

1.1.1.2 Taxation and premiums

In most cases, premiums are payable out of the after tax earnings of the policyholder and there is neither recovery of tax nor additional tax payable in respect of each premium.

However, for a few remaining old contracts, policyholders can benefit from tax relief on premiums payable up until 5 April 2015, at a rate laid down by the government (currently 12.5% of the premium), if:

- the contract is qualifying; and
- the contract was taken out before 14 March 1984; and
- the contract has not been subsequently varied.

In these cases, the policyholder pays premiums net of the tax relief and the life insurance company recovers the relief from HM Revenue and Customs ("HMRC"). HMRC was formed in 2006 by the merger of the Inland Revenue and HM Customs and Excise.

It can also be noted that a limit of £3,600 has been introduced on the annual premiums that can be paid into qualifying life insurance policies issued on or after 5 April 2013.

1.1.1.3 Taxation of policy benefits

A tax charge on the policy benefits received by the policyholder (or the policyholder's estate) may apply:

- at maturity or on death, surrender, part surrender or sale, if the contract is non-qualifying

- on surrender, part surrender or sale within 10 years, or three-quarters of the term if less, if the contract is qualifying.

Where tax is payable, it is paid on the excess, if any, of the benefits received over the total amount paid in premiums ("the gain") and is referred to as "chargeable gains tax".

Where the tax charge arises on death, it is assumed for calculating the amount of tax that the benefit received is the surrender value of the contract immediately prior to death.

In the case of a part surrender, the tax charge only applies to the excess of the amount received over 5% per annum in respect of each premium paid. A surrender of bonus on a qualifying policy counts as a part surrender.

The position on a subsequent part surrender is complicated and knowledge of how the tax is calculated is not required for this Subject. On the final surrender of the contract, the total taxable amount equals the total gain less what has previously been taxed. If the latter exceeds the total gain, a policyholder can claim deficiency relief against other income.

Tax is paid on any amount liable to tax at a rate equal to the policyholder's marginal tax rate less the lower rate (charged on savings) of tax (as at April 2012 the lower rate is 20%). Usually chargeable gains tax is payable only by higher rate tax payers whose marginal rate of tax is 40% (April 2012) giving a chargeable gains tax rate of 20% (and correspondingly higher for those whose earnings are in excess of £150,000 and so subject to the higher tax band introduced from April 2010, the marginal tax rate for which was initially 50% and then 45% from April 2013). Basic rate tax payers are not charged.

Top-slicing relief is available, but knowledge of how this relief is calculated is not required for this Subject.

1.1.2 General annuity contracts

This covers annuity contracts that are not associated with pension arrangements. In the case of immediate annuities, they are often referred to as purchased life annuities to indicate that they are taken out at the discretion of the policyholder. In the case of deferred annuities which terminate before the vesting of the annuity, the policyholder will be liable to tax in the same way as for a non-qualifying life assurance policy.

No tax relief is available on the premium(s) in respect of these contracts.

The policyholder — or annuitant — has to pay tax on the benefits received by way of annuity payments. A charge to tax will also arise where a company pays out a lump sum either on surrender or death.

With certain exceptions, these contracts qualify for what is known as a "capital content". The annuitant is then liable to tax on the amount of each annuity payment that exceeds this capital content. This excess is referred to as the "income content". The capital content for an immediate annuity is obtained by dividing the premium by an expectation of life at the commencement of the annuity, based on a mortality table specified by HMRC.

The expectation of life takes into account the mode of payment of the annuity, any guarantee period and any fixed rate of increase.

The liability to tax on the income component is at the annuitant's full marginal rate of income tax.

Different rules apply to annuities purchased before 1992 but knowledge of these rules is not required for this Subject.

1.1.3 Pension contracts

1.1.3.1 Tax regime effective from 6 April 2006

Pensions business is regarded as a tax favoured savings environment and so there are restrictions on the extent to which the environment can be used. The restrictions apply to both the annual permitted contributions and the amount of the total accumulated investment.

With effect from 6 April 2006 major changes were made to the tax regime for pensions. The government's intention in replacing eight tax regimes with one single regime, covering both personal pensions and occupational pension schemes, was to simplify the rules for the overall pensions tax regime.

The changes introduced more flexibility in terms of how much can be contributed, where the contributions could be invested, and how and when benefits could be taken. Subsequently this flexibility has been reduced as the government has become increasingly concerned to restrict pensions tax relief, particularly for high earners.

An individual can have as many pension schemes as required. Therefore, a member of an occupational pension scheme can contribute to a personal pension scheme or any number of personal pension arrangements.

The restrictions affecting contribution levels, benefits and investments are outlined below. No further detail is required for the purposes of Subject SA2. Further changes should be expected in the future.

1.1.3.2 Contributions

There are two main allowances for pension contributions. The first is the limit on tax relievable personal contributions. This allows an individual to obtain tax relief on contributions up to £3,600 per annum or their full taxable UK earnings if higher. Normally these will receive basic rate tax relief within the fund (i.e. currently 20%).

The life insurance company will recover the tax at the basic rate only and a policyholder who is a higher rate taxpayer will need to recover the balance as part of the settlement of his/her personal tax liability through his/her annual tax return.

There is also an annual limit on how much can be contributed in total by an individual and his or her employer. Contributions are measured over a period which is normally a year and can be aligned with the tax year. This limit is the “annual allowance” which was £255,000 for the tax year commencing April 2010, but was reduced to £50,000 with effect from 6 April 2011. However, there is a facility to carry forward any unused annual allowance from the preceding three tax years. Contributions in excess of the annual allowance, including any unused amount carried forward, are not eligible for tax relief. The limit applies to all savings in pension schemes in which an individual builds up benefits.

For defined benefit occupational pension schemes the amount of pension savings for annual allowance purposes is not the contribution paid but is a derived amount based on the increase in the value of the benefits. The detail of this is outside the scope of Subject SA2.

Employer contributions will only attract tax relief if they are wholly and exclusively for the purposes of trade.

There are other detailed rules applying to the tax regime for pension contributions but knowledge of these is not required for Subject SA2.

1.1.3.3 **Benefits**

Benefits taken as a pension are taxed as earned income and so to the extent that the pension payments push the policyholder's earnings into the higher rate tax band, that part of the pension will be taxed at the higher rate. In principle, on retirement an individual can not only draw a pension but can take part of the benefits available as a lump sum (that is currently free of tax) and/or as a contingent dependant's pension.

A main change under the new tax regime (from April 2006) was the introduction of the "lifetime allowance". An individual's pension is based on the total funds built up under all pension arrangements with a limit of £1.5m for the tax year commencing 6 April 2006. The limit increased in stages to £1.8m in 2010, but then reduced to £1.5m with effect from 6 April 2012.

The lifetime allowance is the upper limit on an individual's total tax advantaged pension savings. Hence it will influence pension funding. It is possible to have a fund larger than the limit but there will be an additional tax charge normally only applicable when the benefits are put into payment or paid as a lump sum on death. The details of the additional tax charge are not examinable.

Another area of change from 2006 related to tax-free lump sums. Under the current tax regime, the "pension commencement lump sum" is standardised at 25 per cent of the total fund(s). Protection is available for greater lump sum rights built up before 6 April 2006.

If the value of an investor's total pension funds across all registered pension schemes does not exceed £18,000, it is possible to take the funds as a cash sum rather than having to take at least 75% of it in the form of an annuity. The trivial commutation rules also allow any individual pension funds of £2,000 or less to be taken as cash, irrespective of other pension savings.

It is also possible to take a (currently tax-free) lump sum from AVC and FSAVC contracts. This was not normally allowed before 6 April 2006.

As mentioned in Unit 2 (Section 10.1), instead of purchasing an immediate annuity at retirement age, an investor has the option to invest in a product that allows him to withdraw an annual income, up to a prescribed limit, whilst leaving the remaining funds invested. This is known as "income drawdown" or an "unsecured pension".

Before 6 April 2011, these products were subject to restrictive rules once a policyholder reached age 75, which basically required the policyholder to secure an immediate annuity with the remaining funds at that time (if they had not done so already). From 6 April 2011 this "alternatively secured pension" rule no longer applies, and broadly the same rules now apply to income drawdown each year irrespective of the policyholder's age, with the exception that income limits must be reviewed annually once the policyholder reaches age 75.

Under the current rules, the income limit is 100% of a rate set by the Government Actuary's Department that is roughly comparable to the current market annuity rate. The policyholder can vary the income on a year by year basis and may choose to take no income at all.

When an investor dies, any remaining income drawdown funds can be passed to a wide range of beneficiaries as a lump sum (minus a 55% tax charge). Alternatively, the member's spouse, civil partner, child or financial dependant can continue with the income drawdown, or can purchase an annuity with the pension fund.

1.1.3.4 Investment of contributions

The range of allowable investments under the post April 2006 regime is not that different from the previous rules. No tax efficient investment is allowed in residential property in the UK or overseas, or in more exotic investments such as wine and antiques.

The previous "connected party" rules were removed so pension schemes can transact with family members, connected companies, fellow directors and/or partners, provided such transactions are carried out at market value. This could be particularly useful for small companies that already own their business premises in that the property could be sold to the pension scheme.

There may be other changes in the future with the development of new assets such as real estate investment trusts, but in essence the investment solution for most people is the same after 5 April 2006 as it was before.

1.2 Taxation of UK life insurance companies

1.2.1 Classification of business for tax purposes

Before 1 January 2013, for tax purposes a UK life insurance company had to treat the following as separate businesses:

- Basic Life Assurance and General Annuity Business (BLAGAB)
- Gross Roll-up Business (GRB)
- Other Long-Term Business (including PHI and capital redemption)

BLAGAB covered all life assurance and annuity contracts other than pensions business, ISAs, child trust funds, life reinsurance business and overseas life assurance business, i.e. the contracts described in Sections 1.1.1 and 1.1.2 as life assurance and general annuity contracts.

GRB covered all business other than BLAGAB and PHI and so it covered pensions business, ISAs, child trust funds, reinsurance of life assurance and also business sourced from overseas.

From 1 January 2013, the structure has been simplified into two categories:

- Basic Life Assurance and General Annuity Business (BLAGAB)
- Other Long-Term Business (OLTB)

The OLTB category incorporates the previous GRB and PHI categories. It also contains some business that was previously classified as BLAGAB: all life assurance protection business written on or after 1 January 2013 is no longer treated as BLAGAB, but instead forms part of the OLTB category.

For this purpose, "protection business" is broadly defined as any long-term insurance contract "under which the benefits payable cannot exceed the amount of premiums paid, except on death or in respect of incapacity due to injury, sickness or other infirmity".

Life insurance companies which have only ever written protection business may elect to have *all* of their business classified as OLTB.

The remainder of this Unit is based on the post 1 January 2013 tax regime.

1.2.2 The tax payable in respect of the two categories of business

The company has to allocate its trading profit and all component parts of its revenue account between the different categories of its business.

Rules on the apportionment of investment return have been subject to much revision over past years. From 1 January 2013 the allocation of trading profits and investment returns between the two categories must be determined on a commercial rather than a prescribed basis. More detailed knowledge of the apportionment approach is not needed for this Subject.

1.2.2.1 Other Long-Term Business ("OLTB")

OLTB is liable to corporation tax (at the full corporation tax rate) on its trading profits, which is intended to be a reasonably intuitive measure of "profit" made by the shareholder on this part of the business. It can be noted that a mutual company would not normally have a taxable OLTB profit.

The taxable trading profit is derived from amounts brought into account as follows:

$$P + I' + A' - E - C - (V_1 - V_0) - L$$

where

P	=	premiums receivable in respect of OLTB contracts
I'	=	OLTB share of investment income
A'	=	OLTB share of change in value of the assets — this may be negative
E	=	expenses including commission attributable to OLTB
C	=	benefit payments made in respect of OLTB contracts, including terminal bonus
V_0	=	value of OLTB liabilities at beginning of year
V_1	=	value of OLTB liabilities at end of year — including cost of bonuses declared at end of year
L	=	absolute amount of any OLTB loss brought forward from previous year end

Before 1 January 2013 these figures were based on the FSA Returns. From 1 January 2013, they are based on the statutory accounts. Further changes to the determination of OLTB profit are expected when Solvency II comes into force.

Since the move from taxable surplus within the FSA Returns to accounting profit would tend to give rise to an immediate profit or loss, transitional arrangements are in place to bring this into tax over a period of ten years.

1.2.2.2 Basic Life Assurance and General Annuity Business ("BLAGAB")

Tax is payable in respect of BLAGAB on the "I-E" basis (appears as this in tax legislation).

The components of "I-E" are as follows:

I

- Investment income from real estate, gilts, bonds and deposits. Dividend income from equities (both UK and overseas) is excluded as this is already deemed to have suffered tax.

- Realised chargeable gains on real estate and equities, allowing for the effects of indexation in respect of realised gains. Indexation is not applied to realised losses.

- Mark-to-market or mark-to-model capital movements in gilts, bonds and derivatives.

- Miscellaneous income (e.g. reinsurance income).

E

- BLAGAB allocation of expenses, subject to the spreading of acquisition expenses.

- Income component of general annuities.

For annuities taken out since 1 January 1992, the income component of annuity payments is the total annuity payments less the corresponding total capital contents. This reflects the income part of the annuity payments which is not taxable in the life insurance company's hands as a policyholder has to pay tax on it (see Section 1.1.2 above). Knowledge of what the income portion is for annuities taken out before 1 January 1992 is not needed for this Subject.

If E is greater than I, the excess is effectively carried forward and added to the next year's E. Any amount so carried forward is referred to as "unrelieved expenses" or XSE (excess E).

The expenses in E include both administration expenses and commission, but all acquisition expenses, i.e. expenses that relate to the acquisition of new business including all commission payments, have to be spread equally over seven years.

If the company holds units in an authorised unit trust, UCITS or OEIC, the BLAGAB share of the holding is notionally sold and repurchased at the end of each financial year at its then market value. Any gain arising from the notional sale — after allowing for indexation relief — is spread equally over seven years and included in chargeable gains. Where losses arise, there is no allowance for indexation and the losses can be used to restate prior year gains and so accelerate relief for the losses. The restatement cannot apply to more gains than arose in the previous two accounting years.

1.2.2.3 "I-E" computation

Prior to 1 January 2013, the above computation of BLAGAB "I-E" was combined with the GRB profits to form what is called the "I-E" computation. From 1 January 2013, this is now performed on BLAGAB "I-E" only.

The rate of tax is at the policyholder rate (20% as at April 2012) unless any part is deemed to be shareholder profit. In a mutual, it would not be expected that any part would be shareholder profit. In a proprietary company, the shareholder profit would be expected to be material and further calculation is required because HMRC requires part of the profit to be taxed at the more usual rate of corporation tax (24% as at April 2012).

Although this division of "I-E" sounds odd, there is compelling justification for this approach as is shown below. The "I-E" result was historically designed to be a quick and effective calculation of the sum of shareholder and policyholder profit. Policyholder profit can be regarded as the excess of claim amounts over premiums paid and has to arise from profitable investment returns over charges incurred.

So to justify the "I-E" calculation we can consider the classic revenue account statement of profit as follows:

Shareholder Profit = P(premiums) + I(income and gains) - E(expenses) - C(claims)

Here, claims can be considered to be increases in policy reserves plus a claim payment in excess of the opening policy reserve. Policyholder Profit is therefore equal to "C-P" and we can re-express the equality as:

Shareholder Profit + Policyholder Profit = I-E as required!

For proprietary companies, the further steps required to compute the tax bill are summarised in Section 1.2.3 below.

1.2.3 Additional considerations for proprietary companies

1.2.3.1 Apportionment of taxable income between policyholders and shareholders

The aim of the tax legislation is to tax the policyholders' share of the company's taxable income, i.e. the "I-E" computation, at the tax rates that would apply if the company were a mutual, and the shareholders' share at the standard rate of corporation tax. There are special provisions for dividend income.

1.2.3.2 The minimum profits test

The UK tax authorities consider it desirable that as far as possible the taxation of proprietary life insurance companies is consistent with the basis applicable to proprietary trading companies in other industries. Therefore a "minimum profits test" is applied to the "I-E" result. This is also known as the "excess adjusted life assurance trade profits" test, with the minimum profit being referred to as the Life Assurance Trade Profits (LATP). The test was previously known as the Notional Case I test.

The minimum profit is effectively the surplus arising on the BLAGAB business (including BLAGAB share of non-taxable dividends), after a deduction for policyholder bonuses. If it is negative then the minimum profit is taken as zero and a loss can be carried forward to its calculation in the following year.

Otherwise the minimum profit is compared with the result of an adjusted BLAGAB "I-E" computation. The adjusted "I-E" figure is the "I-E" result plus BLAGAB share of dividend income.

If the minimum profit is higher than the adjusted "I-E" computation, then the allowable expenses in the "I-E" computation are effectively restricted so that the two are equal. The amount by which the allowable expenses are so restricted (the "excess adjusted life assurance trade profits") is carried forward as XSE and added to the following year's BLAGAB expenses. When such a restriction applies, the company is frequently referred to as "excess E".

1.2.3.3 Tax rates

The minimum profit needs to be allocated between the part derived from the equity dividend income and the remainder. Details of the allocation are not needed for this Subject.

If the minimum profits test does not bite (i.e. the minimum profit is lower than the adjusted "I-E" figure) then an amount of the "I-E" equal to that part of the minimum profit not derived from dividends is taxed at the corporation rate and the balance at the policyholder rate. If the test does bite then the "I-E" is all taxed at the corporation rate. In both cases the "I-E" value is that originally calculated and so excludes any dividend income.

1.2.3.4 The circumstances when minimum profit exceeds "I"

It is important to note that in certain circumstances the minimum profit may exceed the I in the "I-E" amount including equity dividend income. So even by restricting all E, the tax charged on the resulting I will be less than would be charged if the life insurance company were taxed as any other trading company. In this case, the I is increased so that the increased I equals the minimum profit and the amount of the increase is carried forward in a form that is equivalent to additional restricted expenses.

1.2.3.5 The circumstances in which a company may be excess E

A company that has unrelieved carried forward expenses due to the expenses restriction under the minimum profits test is referred to as having excess E.

For example, this may arise if the company has been recently established so has little value in the form of accumulated investment funds but is incurring relatively onerous expenses, and so has low I but high E.

A company may also temporarily become excess E due to large BLAGAB profits, for example from a weakening of the liability valuation basis, which would result in the minimum profits test biting.

Or it might be due to significant capital falls in the bond market so that the net return from gilts and bonds is negative.

Another common reason for being excess E was where a life insurance company issued significant volumes of BLAGAB contracts that have high expenses relative to investment income, such as protection business. However since new protection business is no longer taxed under the "I-E" basis from 1 January 2013, this will gradually cease to be valid.

1.3 Allowances for tax in unit pricing

Unit-linked funds provide policyholders with a direct link between investment returns on assets and policy benefits. However, life companies will suffer tax on investment returns in respect of BLAGAB funds and so policy conditions typically (probably universally) impute the tax regime applied to the company into an equivalent tax regime applied to the investment return earned by the BLAGAB linked funds. The unit link used to determine policy benefits is then the asset performance link net of the charges and provisions for the imputed tax.

However, it is important to note that the tax charged to the funds does not need to equal the tax charged to the company. Indeed it would be expected that more is charged to the linked funds than is paid to HMRC as a company tends to charge without allowing for relief on expenses.

Specific considerations apply to the way in which tax is allowed for in the pricing of units in respect of funds open to BLAGAB business. These are covered in this section.

Tax would be charged to the linked funds in respect of income received and mark-to-market or mark-to-model gains on gilts, bonds and derivatives in the same way as these are included in the "I" of the "I-E" calculation. ("Mark-to-model" refers to situations such as derivatives where there is no quoted price, and so the price for taxation purposes must be determined by a model).

The tax treatment of realised capital gains and losses for equities and property follows normal capital gains tax rules. In particular, realised chargeable gains are determined after allowing for indexation — based on the changes in the Retail Prices Index — and realised chargeable losses are determined ignoring any indexation. Tax would be charged on the net of the two amounts where positive and would be carried forward to be set against future realised chargeable gains where negative. A similar approach is used for holdings in OEICS and unit trusts where the notional annual sale and repurchase and the spreading of gains is also imputed.

Policy conditions should specify the tax rate used, but in most cases the rate is the policyholder tax rate (20% April 2012).

The company must make a charge on the fund at the time of sale to enable it to cover the liability to tax. The basic principle requires that this charge be equitably apportioned amongst those who benefit from the gain. This is achieved implicitly by making a provision for the potential tax liability as gains arise when valuing the fund for pricing purposes.

At the pricing date a fund will have either net unrealised gains or net unrealised losses. In each case there may be realised losses being carried forward. There can arise, therefore, a number of different tax positions in the fund depending on the relative values of these various elements.

It is important to note that the provisioning for unrealised gains and losses is a unit pricing adjustment that is subject to discretion, because the amount and timing of the tax charge at the time that the gain is realised is not known in advance. Further, where there are unrealised losses or carry forward realised losses, the ability to use the losses to relieve the tax liability on future gains is uncertain. Consequently practices vary significantly and the following details should be regarded as just one of the many variations that may be appropriate in differing circumstances.

In order to simplify the development, consider first a fund which has unrealised gains only.

1.3.1 Unrealised gains

1.3.1.1 Pricing on an offer basis

The appropriation price (the price at which new units are created in funds that receive a net inflow of policyholder investment) must be adjusted to take account of the potential liability to tax on the unrealised gains — after indexation allowances — accrued to the pricing date. In most cases, and particularly with an expanding fund, assets will not be sold immediately and any tax liability on these accrued gains will not crystallise until the assets are sold at some future date.

The company should, therefore, make provision for tax on the accrued chargeable gains using the full tax rate discounted to allow for the period to the expected date of realisation. As indexation relief will be available on future gains, the discount rate is the net real rate of return expected on the fund's assets.

The estimates should be as realistic as possible as there is little that can be done to adjust the position of unitholders who, in retrospect, have gained or lost due to actual experience differing from that expected. Pricing does not differentiate between different generations of unitholders.

1.3.1.2 Pricing on a bid basis

A similar adjustment must be made to the expropriation price (the price at which units are cancelled in funds that suffer a net outflow of policyholder investment). The fund is contracting and a proportion of the assets will be sold regularly to provide the money to pay the unit claim values.

Any tax liability on the accrued gains for the proportion sold will crystallise immediately. Consequently provisioning for tax on the accrued chargeable gains may be subject to less discounting than for expanding funds, or in some cases there may be no discounting.

1.3.2 Unrealised losses

1.3.2.1 Pricing on an offer basis

The treatment of accrued unrealised losses should follow exactly that for unrealised gains, in that losses can be regarded as negative gains. If it is assumed that all assets will be showing gains, after indexation allowances, by the time they are sold, the position is no different from that for accrued gains, except that the adjustment will be an addition to the appropriation price rather than a deduction.

However, if it is assumed that losses will be realised when the assets are sold, some modification is required.

Whereas tax is payable when a gain is realised, no tax is immediately recoverable on realising a loss. The company can only utilise realised losses when offset against subsequent realised gains. The credit for losses in these circumstances should, therefore, be further discounted to take account of this additional period of deferment.

The discount rate for the whole period will be the net money rate of return expected on the fund's assets.

Which approach is appropriate will depend to some extent on the size of the losses relative to the value of the assets. The discounted tax rate for losses should be lower than that for unrealised gains to reflect the risk that the losses will crystallise.

If the losses are relatively small the fund may move reasonably quickly to an unrealised gains position on its asset growth assumptions. The discounted tax rate could, therefore, be only slightly lower than that for unrealised gains.

With large unrealised losses, it is more likely that losses will be realised (which requires use of a higher discount rate as described above) and there will be increased uncertainty of the timing of achieving a net unrealised gain position. Indeed there may be a risk that this never occurs, particularly in contracting funds. Consequently the tax rate is likely to be more heavily discounted, or no value given at all.

1.3.2.2 Pricing on a bid basis

On the normal assumption that assets are being sold and units cancelled, the losses will be realised sooner and credit can be given for them only if chargeable gains are expected to arise against which they can be offset.

1.3.3 Realised losses being carried forward

The treatment is the same as for unrealised losses, except that, when pricing on an offer basis, the credit is determined using the full tax rate discounted at a net money rate of return on the fund for the period until it is expected that the losses will be utilised.

1.3.4 Authorised unit trust investments

Where a fund holds units in an authorised unit trust, the above calculations need to be modified for the annual notional sale and repurchase rule explained in Section 1.2.2.2 above.

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