Tax legislation changed – so what?

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Tax changes and what it means for the Actuarial Profession

- Introduction
- What has changed
- Transition rule implications
- Structural transactions.

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Introduction

Numerous changes, especially last year, changed tax terminology and tax methodology

- Revised categories of business for tax
- Tax based on statutory accounts – rather than regulatory accounts
- Allocation of taxable income
- Protection business – Now non-BLAGAB
- Change to taxation of pension losses
- Lower corporate tax rates

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Categories of insurance business

Insurance

Short-term insurance business

Long-term insurance business

Non-BLAGAB

BLAGAB

Non-BLAGAB long-term business includes:

Pension business ("PB") - Approved pensions on gross roll up

Child trust fund business ("CTFB") – Approved product – gross roll-up

ISA business ("ISAB") - Approved product – gross roll-up

Immediate needs annuities - Approved product – gross roll-up

Life reinsurance business ("LRB") - Roll-up taxed in cedant, gross roll-up in reinsurer

Overseas life assurance business ("OLAB") – Non UK residents not taxed on roll-up (except UK land) so gross roll-up

New life protection business from 1 January 2013 – to remove relief for E

Permanent health insurance ("PHI") – Long-term business which is not life assurance business

Basic life assurance and general annuity business ("BLAGAB")

UK taxpayers - net roll-up with relief for expenses

Excludes new protection business from 1 January 2013

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Use of statutory accounts

- Historically tax calculation used data from the regulatory returns
- Now data will be taken from the statutory accounts
- There are a few interesting features arising
  - There is no “investment reserve”
  - “Unappropriated surplus” is a liability as FFA - UDS
  - Closure provisions and mortality and expense reserves do not feature
  - DAC is taxed! But only the excess over spread initial expenses
  - Contingent loans are automatically liabilities
  - Transitional tax effects are potentially material

The new source of figures creates different tax results and different tax management capacity

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Allocation of taxable income and gains

- Historically income and gains allocated in proportion to pillar 1 liabilities
- Now allocated based on asset allocations used for matching and pricing purposes (commercial allocation basis)
- Again there are a few interesting features arising
  - Modelling taxation of income now more likely to be accurate
  - Reasons for separating business lines to avoid tax inefficiency disappear
  - Allows recombining of business to realise risk diversification and other benefits
  - But it does require detailed definition of the allocation process

The new allocation approach removes a block to efficient capital and liquidity management

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Allocation of taxable income and gains

An example

Block	Liability	Old Equity	Old Bond	New Equity	New Bond
Annuity[1]	1000	33	16	0	50
Pension With Profits[2]	1000	33	16	50	0
Life With Profits[2]	1000	33	**16**	50	**0**
Total	3000	100	50	100	50

[1]Matched 100% with Bonds yield 5%

[2]Matched 100% with Equities yield 5% non taxable

The old allocation basis ignores asset hypothecation used for valuation and pricing

Typically bond coupons can be allocated to BLAGAB and so incur tax

The new allocation basis follows commercial hypothecation which prevents this miss-allocation

Stops potential misallocation of annuity bond income to taxable BLAGAB

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Expense relief

- Mortality protection business no longer part of BLAGAB
- Either increases premium rates …….
- ... or reduces profits for those that obtained expense tax relief
- Changes the tax characteristics of companies
- XSE tax assets more likely to be realised
- And tax volatility less likely once XSE assets are realised
- But volumes of income generating BLAGAB are low

Term assurance tax subsidy stops

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Non-BLAGAB taxation (Pension business etc)

- No longer taxed as part of I-E
- Previously pension losses reduced shareholder losses
- But left I-E unchanged so loss relief limited shareholder minus policyholder tax rate
- Now non-BLAGAB profit is taxed separately and losses get full rate of loss relief
- Incentive to separate BLAGAB and non-BLAGAB is removed

Removes an incentive to separate BLAGAB from non-BLAGAB

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Shareholder tax rates

- From April 2013 – 23%
- From April 2014 – 21%
- From April 2015 – 20% ?
- Do we want the 2015 rate to be “substantively enacted”?
- Good for reducing tax on profits
- Bad for the value of tax assets
- Note the shareholder rate and policyholder rate may be the same

Need to watch the rates used to value tax assets

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Transition rule implications

- Transitional adjustments
- How and when they are taxed
- Deferred tax
- Impact on capital
- Shareholder fund assets
- Losses

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Long-term business transitional adjustments

- The basis of determining trade profits changed from 1 January 2013 from the use of regulatory surplus to financial statements profit
- A total transitional difference is calculated at 31 December 2012
- The total transitional difference is analysed fund by fund between excluded (not taxable) and relevant computational (taxable) items
- Items, such as deferred acquisition costs, deferred income reserves and deferred tax on accounting profits, are excluded either to avoid double taxation or because they are not normally taxable in trade profits
- Relevant computational items, such as differences in admissible asset values and prudential reserves not in the accounts, affect both BLAGAB and non-BLAGAB trade profit computations
- Positive relevant computational items are taxed and negative relevant computational items are relieved
- Impact spread in equal instalments over ten years 2013 to 2022.

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Apportionment of relevant computational items between BLAGAB and non-BLAGAB

General principle

- Use current basis of allocation
- Direct attribution for linked asset amounts and liabilities
- With profits items split in bonus ratio, and non profit items by mean liabilities of the non profit fund

Which amounts

- Only applies to relevant computational items
- Does not apply to excluded items
- Separate determination for each with-profit fund and the non-profit fund.

Allocation should be the same as that used to determine deferred tax on acceleration of profits under current regime to minimise impact on reported profits

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Timing of adjustment

- Impact spread in equal instalments over ten years 2013 to 2022
- Unless,
  - relates to amount in a non-profit fund the distribution of which is prohibited by a court order when deemed receipts deferred by up to 2 years (ie to 2015 to 2024)
  - transfer of business to a non-group transferee, or other cessation of category of business when remaining relevant computational items brought in as receipts or expenses immediately
- But
  - spreading continues where there is a transfer within a group of companies.

Predictable impact can be taken into account in loss planning

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Deferred tax

- Deferred tax will be needed where excluded items such as deferred acquisition expenses will amortise without relief
- Deferred tax will also be needed for relevant computational items until they fall into charge
- Differences in respect of deferred tax on trade profit items are excluded
- Amounts in respect of deferred tax shown in mathematical reserves or technical provisions are extracted and treated as deferred tax
- Differences in respect of deferred tax on I minus E items are excluded if there is a net deferred tax liability in the financial statements
- Differences in respect of deferred tax on I minus E items are a relevant computational item if there is a net deferred tax asset in the financial statements
- Yearly movements in deferred tax on I minus E items are then taxed or relieved in BLAGAB trade profits.

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Transition – impact on capital

2012 position

As trade profits are based on Solvency I surplus, only I minus E items generally considered. Conservatism in FSA return will tend to result in current tax relief.

2013 position

As trade profits are based on financial statements, differences in profit recognition need to be considered. Relative conservatism in FSA return will tend to result in inadmissible deferred tax assets.

Solvency I capital may be reduced

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Assets of the shareholder fund

- Assets of the shareholder fund at transition become assets of the long-term business fixed capital
- Rule does not apply if income and gains are currently included in trade profits
- Lack of certainty on replacement assets:
  - Legal basis - capital v revenue or circulating v fixed capital
  - Commercial allocation by reference to investment pool.

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Carry-forward of losses and expenses

- PHI trade losses become non-BLAGAB trade losses
- Old GRB losses become non-BLAGAB trade losses
- Life assurance trade losses become BLAGAB trade losses but only to the extent that they exceed old GRB losses
- Excess E and allowable capital losses are carried forward unchanged.

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Structural transactions

- Part VII transfers
- Reinsurance
- Financial transactions tax

Part VII transfers

- Projections need to be on a financial accounting basis
- Accounting for the transfer needs to be determined in advance
- Pure accounting items such as DAC and deferred tax do not transfer
- 3rd party transfers follow the financial statements:
  - Profits and losses fall into tax
  - PVIF is recognised for tax and future amortisation deductible
- Intra-group transfers are tax neutral but differences in reported values of assets and liabilities are aggregated and included as profits or losses in the transferee
- Transfers between with-profit and non-profit funds are treated as 3rd party.

What is taken into account for tax on a transfer

- The net amount "recognised" by an insurance company in respect of the transfer of the contracts is determined by subtracting
  - the total amount recognised in respect of liabilities relating to the transferred contracts in a balance sheet drawn up immediately before the transfer in the case of the transferor or the time immediately after it in the case of the transferee, from
  - the total amount that is or would be recognised in respect of assets relating to the transferred contracts in such a balance sheet
- The difference in the net amounts is to be taxed or relieved
  - Taxed, if, when added to the net amount actually recognised by the transferor, the result is the net amount recognised by the transferee, and
  - Relieved if, when subtracted from the net amount actually recognised by the transferor, the result is the net amount recognised by the transferee

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Intra-group transfer - example

Transferor		Transferee	
Assets	100	Assets	100
Liabilities	80	Liabilities	70
Net amount	20	Net amount	30
		Difference	10

As adding the difference to the net amount in the transferor gives the net amount in the transferee, the difference is positive and is a taxable receipt to the transferee

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Reinsurance

- Tax should follow financial statements at company level
- Contract of insurance or financial instrument?
- Arm's-length principle supported by adequate documentation must be applied to tax cash flows between connected parties
- 3rd party reinsurance of BLAGAB investment risk still subject to imputation of investment return for I minus E

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Reinsurance as a financial instrument

- Not a "lending of money" so not a "loan relationship"
- If settlement is in money, would be a "money debt"
- Interest on money debts is deductible for tax
- "Fees" for cashless reinsurance should be deductible in trade profits
- If effective at creating surplus under Solvency I, can give rise to distributable profits for shareholders
- Profit emergence taxed when reflected in income statement

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Imputation of investment return on BLAGAB investment reinsurance

- An approach consistent with commercial allocation could:
  - apply only to reinsurance of investment risk
  - look to the movement in reinsurance balances for quantification
  - look through to the allocation of income and gains allocated to the contract by the reinsurer where the aim is to access particular investment pools.
  - treat investment guarantee contracts as quasi-derivatives with some falling into the chargeable gains regime and others into loan relationships.
- Other amounts receivable, such as commission would continue to be taxable
- Where there are deposits back or funds withheld, the simplest approach would be to ignore the reinsurance to that extent. There would be no deduction in I minus E for deposit back interest or for the investment component of any amount ceasing to be withheld. Alternatively, the imputed income could be set at an equal amount.
- Policy discussions with HMRC continue

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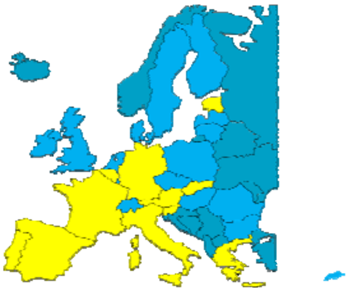
Financial transaction tax ("FTT")

- Agreed for introduction by 11 Member States



Note
Ireland, Luxemburg, Malta, Netherlands and UK are not included

- Due to commence on 1 January 2014
- Other transaction taxes prohibited

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FTT subject matter

- Applies to transactions in financial instruments including both securities and derivatives
- Exchanges are two transactions
- Exemption for:
  - Issuance of securities
  - Restructuring operations
  - Transactions with certain EU central bodies
  - Central counterparties
  - Member States
  - But not intra-group transactions

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FTT scope

- Securities and derivatives issued within the 11 states wherever and between whomever transacted
- Transactions involving financial institutions established in the 11 states:
  - By Freedom of Services authorisation
  - By residence
  - By branch
  - But not if it can be proved that there is no link between the economic substance of the transaction and the territory of the relevant state

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FTT liability

- Minimum rate 0.01% for derivatives and 0.1% for other assets
- Each party liable to tax (total tax per trade is 0.2%)
- Monthly payment locally by 10th of following month
- Recourse to counterparty if tax not paid.

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