The Actuarial Profession
making financial sense of the future

Life Taxation Workshop
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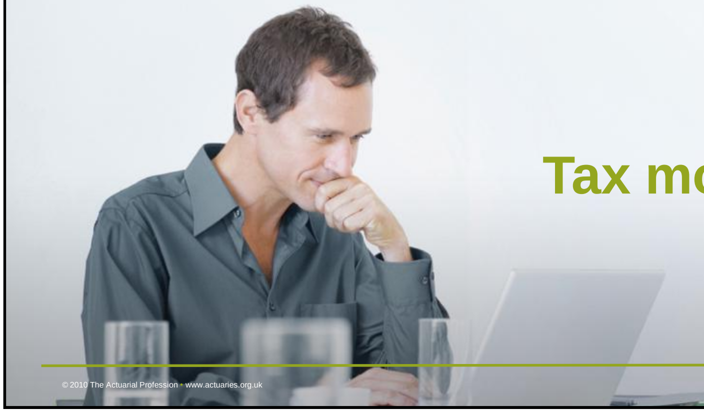

Tax modelling and Planning

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Tax Modelling and Planning

Agenda

- Tax modelling
- Tax planning
- Treating customers fairly

Tax Modelling

Potential areas requiring tax modelling

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

Tax Modelling: by business lines or globally?

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

Examples:

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

The "approximate way" for allowing for tax in practice

	BLAGAB	OLTB
End piece calculation	Tax on shareholders profits over the 20%	Tax on shareholders profits at 24%
Modelled in policy projection routines	Tax on policy income less expenses at 20% rate	

Modelling limitations

Other shortcomings of projection models:

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

Actuarial calculations: allowing for tax

Valuation tax rates: Peak 1

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

Actuarial calculations: allowing for tax

RBS (Peak 2)

- Use of global model for stochastic runs is impractical, and so limitations are:
  - Manual adjustments are not practical
  - Economic scenarios generate gains **and losses.** Tax modelling in projection routines rarely allows for deferral of tax relief on losses
  - Losses typically complicate the tax calculation
- An 'approximate approach' for stochastic runs results in simplifications:
  - Complex if XSE
  - S/H FII unlikely to be correct; and
  - Often assumes all losses can be relieved immediately

Actuarial calculations: allowing for tax

ICA (Pillar 2)

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

Actuarial calculations: allowing for tax

Embedded Value Reporting

- Traditional EV/ Market Consistent EV / Appraisal Values
- Use ‘approximate’ approach
- Value of XSE
- Tax on shareholders’ profits at 24%
- Rate changes to factor over time [26%/25%/24%/23%]

Accounting

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

Unit pricing

- Allowance for unrealised capital gains and losses

Recognition

Actuarial calculations: allowing for tax

Solvency II

- Similarities with ICA, but differences
- SII base position
  - Policyholder tax allowed for in best estimate liabilities
  - Shareholder tax held outside of best estimate liabilities as DTL but typically modelled as 4% or 24% to the change in surplus and so BLAGAB misses the complex interactions with I-E
  - Change in level of deferred tax assets/liabilities to reflect a shift in surplus (SI to SII) relative to the tax basis.
  - Deferred tax assets and Liabilities to be valued in accordance with Article 11 V7
- SCR
  - loss absorbency of deferred taxes (DTL) in relation to trade profits to reduce SCR

Apportionment - example

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

With-profits fund with:

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

Assets
- £100m of gilts matching protection and annuities – 5% return
- £200m of equities matching with-profits – dividends 3% growth 2% (RPI 3%)

Apportionment - example

	Gilt	Equity	
Preferred allocation	Income	Income	Tax
£100m of BLAGAB With-Profits	0.00	5.00	0.00
£100m of GRU With-Profits	0.00	5.00	0.00
£100m GRU annuities	5.00	0.00	0.00
Total			0.00

Apportionment - example

Apportioned allocation	Gilt Income	Equity Income	Tax
£100m of BLAGAB With-Profits	1.66	3.33	0.33
£100m of GRU With-Profits	1.66	3.33	0.00
£100m GRU annuities	1.66	3.33	0.00
Total			0.33

Tax planning

Objectives for actuaries

Forward looking

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

Tax planning

Examples

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

Value of tax assets

Tax assets include the following:

- Unrealised/realised losses in unit funds
- Unrelieved expenses (XSE plus deferred relief on acquisition expenses)
- Unutilised Losses
- Interaction of Minimum Profits Test

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.

TCF - Treating customers fairly

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

TCF - ABI Guide of Good Practice for UL Funds

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

- Policyholders should be treated fairly.
- The firm's approach to tax should be consistent with marketing literature and policy documentation. The firm, if appropriate, should amend marketing literature and policy documentation when changes in tax regimes arise.
- The firm should document how its chosen basis of taxation meets its aims, including if appropriate broad equity between generations of policyholders and fairness between the company and the fund (+).

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