

# **Use and Valuation of NCI Losses**

## **Actuarial Profession Life Office Taxation Working Party**

### **2003**

#### **Use of NCI Losses**

In the Finance Act 2003, legislation was changed to allow shareholder losses in life companies to be carried forward and to be used to reduce future tax liabilities. This brings life companies into line with the existing treatment of losses for all other companies although losses for 2001 and earlier remain excluded from this new treatment.

The NCI profit (“A”) calculated in this part of the legislation is used to determine, *inter alia*, two items:

- the shareholders’ share of relevant profits; and
- the shareholders’ share of UK dividends

The section had previously been used to determine the shareholders’ share of FII, ie UK dividends gross of a 10% tax credit, but for dividends on or after 9 April 2003 the references to FII in the life tax rules were substituted by references to (net) UK dividends as a result of another of the changes in Finance Act 2003.

The issue at question is whether the definition of profits used should allow for brought forward losses or not. The original definition in section 89(7) merely stated that the profits should be computed “in accordance with the provisions of the Taxes Act applicable to Case I of Schedule D.” Section 89(3) then defined “A” as the NCI profits for the period. This last phrase was used as the basis for an argument that brought forward losses were excluded in determining “A” because they were not “for the period”.

The issue is important since it will affect the amount and timing of tax payable. Before 2 July 1997, it was not clear whether it was in general more favourable to life companies to allow for losses brought forward. In the first case the *lower* the shareholders’ share the less tax is payable since less of the relevant profits is taxed at the full rate of corporation tax; in the second case the *higher* the shareholders’ share the more shareholders’ FII was available to frank dividends paid by the life company – this no longer applies since the abolition of advance corporation tax. Companies argued for whatever they thought was in their interest at the time. This was obviously an unsatisfactory situation and the Inland Revenue agreed to sustain in all cases the argument that the definition excluded losses brought forward. The result was that NCI losses brought forward were of no value to a company with XSI. NCI losses have however always served to reduce the NCI comparator in determining minimum profits where there is XSE.

This position is amended by the Finance Act 2003. Paragraph 7 of Schedule 33 allows the carry forward of losses in the calculation of “A” from 1 January 2003, albeit restricting those losses initially to those incurred in 2002.

## Value of NCI Losses

The value of any NCI loss at the valuation date depends on the projected tax position of the company.

### *Company with persistent XSE*

In this case the value of the NCI losses is the discounted value of the tax saved - or up to 30% of the discounted value of the loss, 30% being the shareholders' tax rate. Note that the existence of any XSE at the valuation date is irrelevant.

### *Company with persistent XSI*

If the company is projected to become persistently XSI, then if there were XSE alone the value of the XSE would be again be the discounted value of the tax saved using the policyholder rate. A different situation arises if as well as XSE we also have a NCI loss. When total relevant profits are being taxed, part is taxed at a policyholder rate and part at a shareholder rate. The latter is the NCI profit and the former is the balance. When losses brought forward are taken into account XSE reduces the total relevant profits taxed, but if there is only XSE it is the part taxed at 20% which is reduced. With both XSE and NCI losses not only are total relevant profits reduced, but the part of relevant profits taxed at 30% is reduced - see the diagrams below. (Note: In the above description the NCI loss is assumed to be equal to the XSE and complications arising from franked investment income/dividends have been ignored).

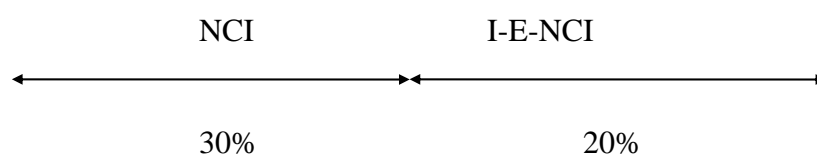
#### *Before Loss*



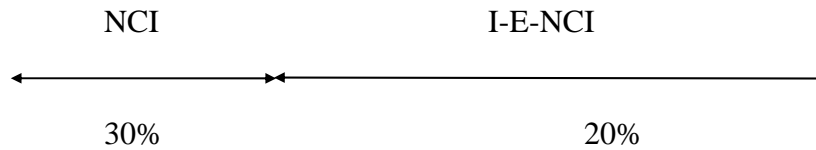
#### *NCI Only*



#### *XSE Only*



## *XSE and NCI Loss*



In fact the reduction in tax will depend on the comparative size of XSE and NCI losses as well as the relevant I minus E and NCI profits going forward. The actual tax position of a company can be very complicated and the scenarios illustrated below only show some simplified examples. In the following we assume that the tax rate on policyholders' income is 20% and the tax rate on shareholders' income is 30%. The following table shows the tax payable and profit for one year in the case of a non profit company.

Relevant profits for the year = 100

Pre tax surplus for the year = 50

Value of Tax Losses				
NCI loss brought forward	0.00	10.00	0.00	10.00
XSE brought forward	0.00	0.00	10.00	10.00
Policyholders' tax	12.50	15.00	10.00	12.50
Shareholders' tax	11.25	7.50	12.00	8.25
Total tax	23.75	22.50	22.00	20.75
Gross NCI	37.50	25.00	40.00	27.50
Net NCI profit	26.25	27.50	28.00	29.25
Value of losses		12.5%	17.5%	30.0%

The relevant profits are the quantum of I-E, and the pre tax surplus is the premiums plus investment income less claims and expenses etc., before *any* tax is deducted. The value of the loss is calculated as the increase in the profit divided by the amount of the loss, e.g. where there are both types of losses in column four the calculation is  $(29.25-26.25)/10 = 30\%$ . Note that in this case there are two types of loss, but the divisor is still only ten; this is so since there is only one business, although the loss manifests itself in two different ways.

Notice that the effective tax rate is not merely 10% (i.e.  $30\% - 20\%$ ) or 20%. This is due to the interaction of the way in which shareholders' and policyholders' tax is calculated.

In the case where there is only an NCI loss brought forward the gross NCI reduces by more than the amount of that loss, due to the change in policyholder tax, itself due to the change in allocation of the same total relevant profit between that attributed to policyholders and that attributed to shareholders. In the case where there is only XSE a similar effect happens, but in the opposite direction (see diagrams). In the case

where there are both NCI and XSE losses, the relevant profit is the same as in the case where only XSE is brought forward, but the presence of NCI losses reduces the effect on tax measured by percentage of loss. Comparing columns three and four above we have:

- a reduction in the total amount of tax payable of 1.25 (i.e.  $(30\%-20\%) * (10 + (20\% * 10) / (100\% - 20\%))$ ) because it shifts 10 from being treated as shareholders' income to being treated as policyholders' income and gives relief for the policyholder tax on that income, but
- the losses used are 10 XSE and 10 NCI

This is the expected result since the statutory relief for E is 20% but for NCI losses 10%.

In reality it may be necessary to examine the projected profits for a number of years until the impact of losses brought forward has run off. The table below shows some examples of this situation and the effect of discounting is also taken into account.

Relevant profits for the year = 100

Pre tax surplus for the year = 50

Five Year Projection: Net NCI						
		Year				
	PVFP	1	2	3	4	5
No losses	99.51	26.25	26.25	26.25	26.25	26.25
NCI = 100	109.69	30.00	30.00	30.00	27.50	26.25
XSE = 100	114.69	35.00	35.00	26.25	26.25	26.25
NCI = XSE = 100	126.08	50.00	30.00	28.75	26.25	26.25

If the above scenarios are repeated, but with a basic pre tax surplus of 40 instead of 50, then the value of the losses changes. In summary

Value of Losses			
	NCI only	XSE only	XSE and NCI
Pre Tax Surplus = 50	10.18%	15.19%	26.57%
Pre Tax Surplus = 40	9.48%	15.33%	26.11%

A number of comments can be made:

- The value of the XSE is less than 20% because the total tax saved is only 17.5% due to a shift from amounts being taxed at the policyholder rate to being taxed at the shareholder rate; the rest of the effect is due to discounting

- The amount of tax saved when there is solely XSE is the same whether pre tax surplus is 50 or 40, but there is a smaller deferral of tax when PTS is 40 since the XSE is used more quickly and hence the value is greater
- As explained above the presence of an NCI loss affects the value of the losses in two ways (although note it does not double the value since there is only one business)
- The impact of an NCI loss is lower in the case where the pre tax surplus is lower. In both cases there is a shift from shareholder to policyholder tax, but the effect of relieving the NCI restriction is less in the former case.

The above examples give some insight into the effects at work, but it should be clear that only a full projection of tax with and without losses will be able to quantify the impact of those losses.

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2003