The Actuarial Profession
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Institute & Faculty of Actuaries

Life Office Taxation Course

Disclaimer

- The information contained herein is of a general nature and is not intended to address the circumstances of any particular individual or entity. Although we endeavour to provide accurate and timely information, there can be no guarantee that such information is accurate as of the date it is received or that it will continue to be accurate in the future. No one should act on such information without appropriate professional advice after a thorough examination of the particular situation.

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Introduction

Gavin Coates

Programme

9.30 am	Course Introduction	Gavin Coates	1.30 pm	Notional Case 1 taxation	Jenny Coletta
9.45 am	Life Office Tax Overview	Steve Jones	2.20 pm	Breakout session: Example 2	
10.15 pm	'I-E'	Jenny Coletta	3.15 pm	Review of Example 2	
11.00 am	COFFEE		3.30 pm	TEA	
11.15 am	Apportionment	Gavin Coates	3.45 pm	Tax implications for actuarial modelling and planning	Paul Turnbull
11.50 am	Breakout session: Example 1		4.20 pm	Other issues	Gordon Gray
12.35 pm	Review of Example 1		4.50 pm	Conclusions and Questions	
12.50 pm	LUNCH		5.00 pm	Close	

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Life Office Tax Overview

Steve Jones

Introduction

- Why worry about tax?
- Tax modelling: by individual business line or globally?
- A simplistic tax model
- A case study
- Some complications
- Some practical investigations

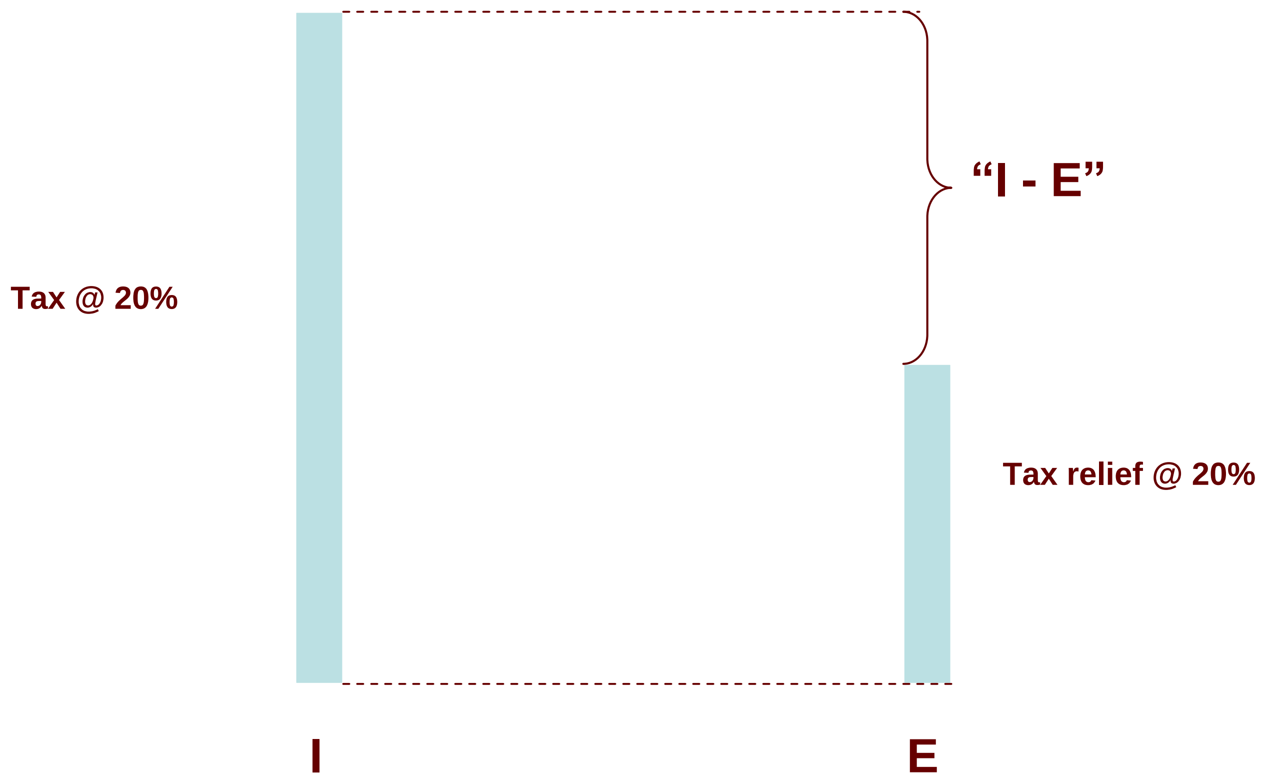
Why worry about tax?

- 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

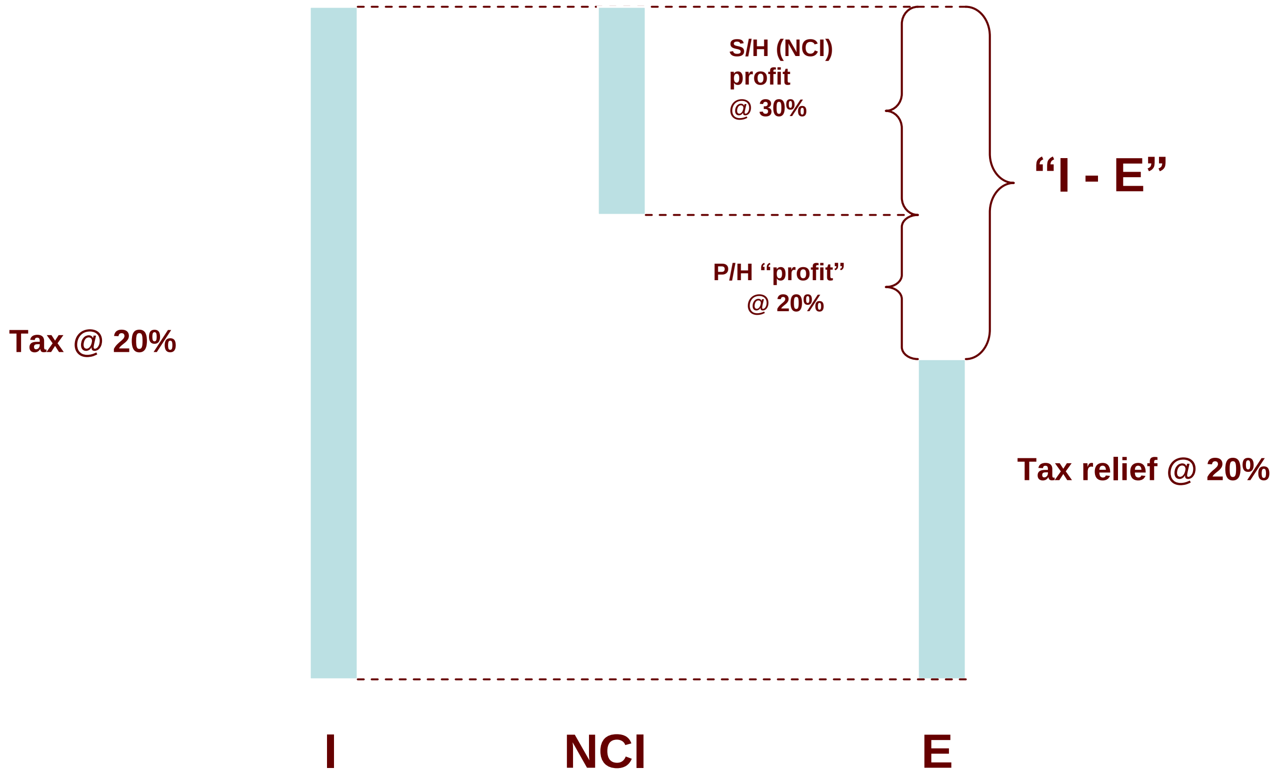
Tax modelling: by individual business lines or globally?

- Most reserving / profit-testing models (Prophet, Moses, …) 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!

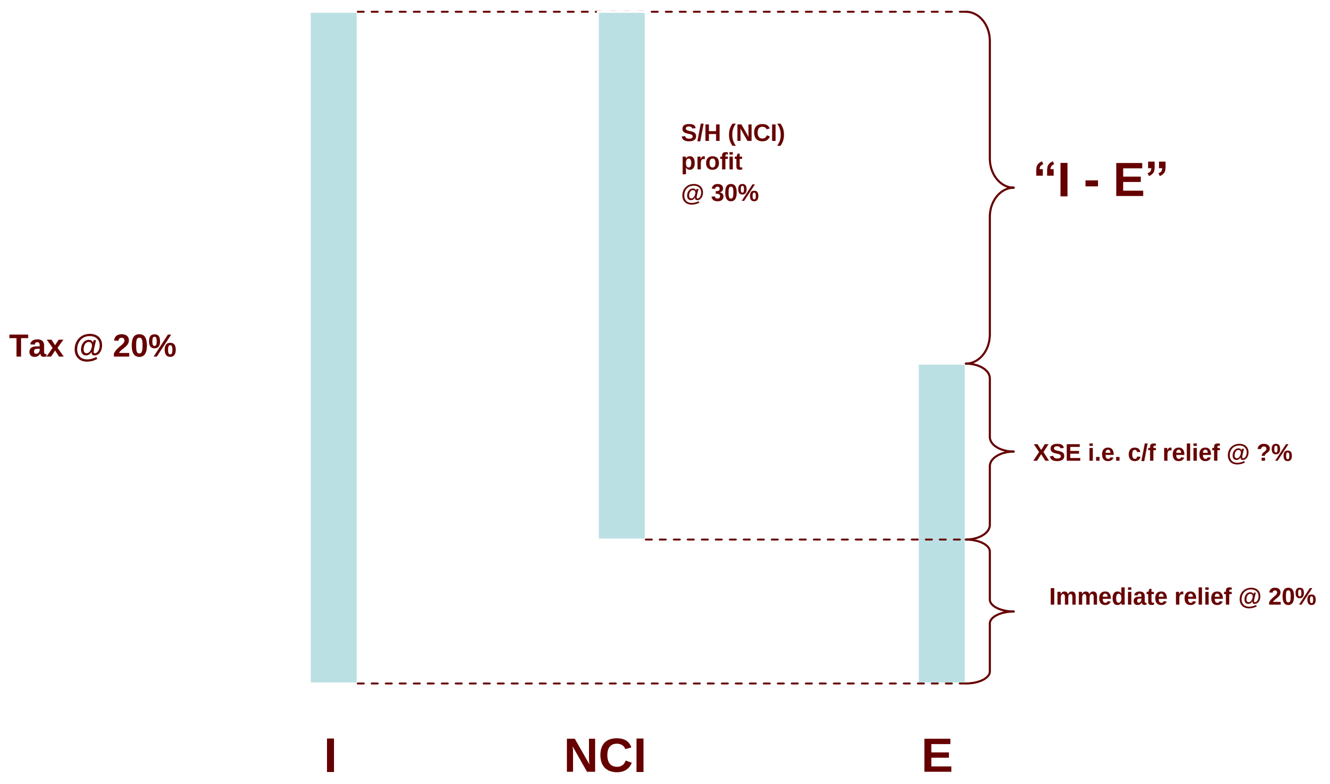
Simplistic tax model: Mutual



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



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



A case study

- Proprietary life office selling Life protection business
- New business creates lots of E and some NCI, but little I
- Premium split: 55% claims, 40% expenses x (1 - 20% tax relief) = 32%, 5% cost of capital = 8% profit [individual business line tax model, no discounting]
- But you only get tax relief on E if the office is generating I … no tax relief = no profit on the contract
- … so need to sell Excess I business (investment bonds)

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

Case study: protection + easy-to-sell investment business (1)

	Protection	Investment	Global adj.	Total
Pre-tax profit	0	9	0	9
I - E	(40)	40	0	0 (+ 0 XSE c/fwd)
P/h tax (on I-E)	8	(8)	0	0
S/h tax (on NCI)	0	(1)	0	(1)
Post-tax profit	8	0	0	8

Case study: protection + easy-to-sell investment business (2)

	Protection	Investment	Global adj.	Total
Pre-tax profit	0	18	0	18
I - E	(40)	80	0	40 (+ 0 XSE c/fwd)
P/h tax (on I-E)	8	(16)	0	(8)
S/h tax (on NCI)	0	(2)	0	(2)
Post-tax profit	8	0	0	8

Case study: protection + hard-to-sell investment business (1)

	Protection	Investment	Global adj.	Total
Pre-tax profit	0	5	0	9
I - E	(40)	40	0	0 (+ 0 XSE c/fwd)
P/h tax (on I-E)	8	(8)	0	0
S/h tax (on NCI)	0	(1)	0	(1)
Post-tax profit	8	(4)	0	4

Case study: protection + hard-to-sell investment business (2)

	Protection	Investment	Global adj.	Total
Pre-tax profit	0	10	0	10
I - E	(40)	80	0	40 (+ 0 XSE c/fwd)
P/h tax (on I-E)	8	(16)	0	(8)
S/h tax (on NCI)	0	(2)	0	(2)
Post-tax profit	8	(8)	0	0

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?

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 16% rather than 20%
- Not always allowed to count deferred E or XSE for valuation purposes
- Valuation should be cautious if usage isn't certain

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

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

Summary

- Why worry about tax?
- Tax modelling: by individual business line or globally?
- A simplistic tax model
- A case study
- Some complications
- Some practical investigations

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The “I-E” Calculation

Jenny Coletta

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
PB/OLAB/LRB/ISAB Case VI profit		x
Less: expenses of management		(x)
capital allowances		(x)
Taxable I minus E result		x

Basic Life Assurance and General Annuity Business ("BLAGAB") - (s431F ICTA 1988)

Life assurance business (including reinsurance business) other than pension business, life reinsurance business or overseas life assurance business

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
PB/OLAB/LRB/ISAB Case VI profit			x
Less: expenses of management			(x)
capital allowances			(x)
Taxable I minus E result			x

BLAGAB Investment Income

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

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
PB/OLAB/LRB/ISAB Case VI profit		x
Less: expenses of management		(x)
capital allowances		(x)
Taxable I minus E result		x

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

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
PB/OLAB/LRB/ISAB 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 and interests in offshore funds	X
	X

Annual deemed disposal of unit trusts

Section 212 TCGA 1992

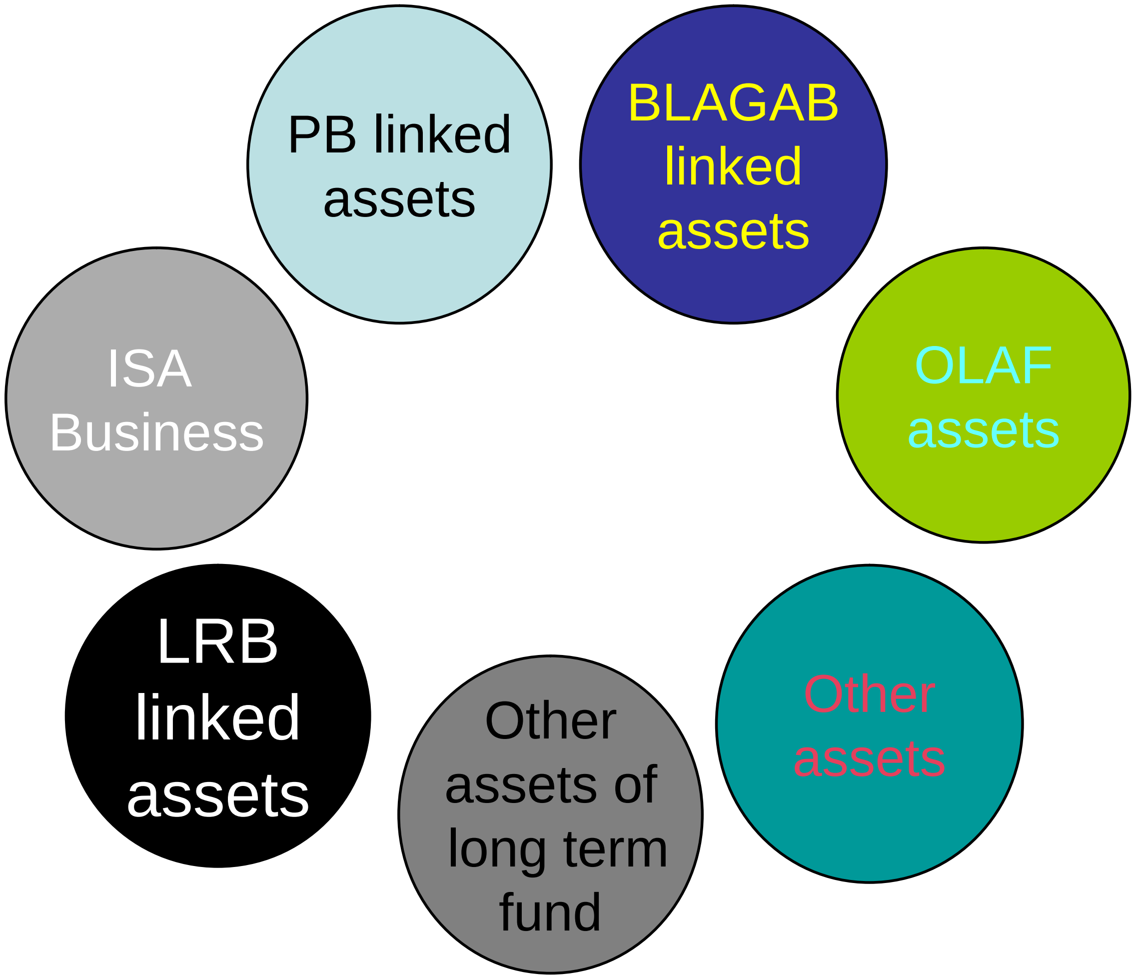
- Where an insurance company holds units in authorised unit trusts (or relevant interests in an offshore fund) in its long term fund, there is a deemed disposal and reacquisition of those units or interests at market value at the end of the accounting period

- 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 as a result of FA 2003 (previously six year carry back)

Capital gains ‘boxes’



Chargeable gains ring-fencing

Further restrictions were introduced in FA 2003:

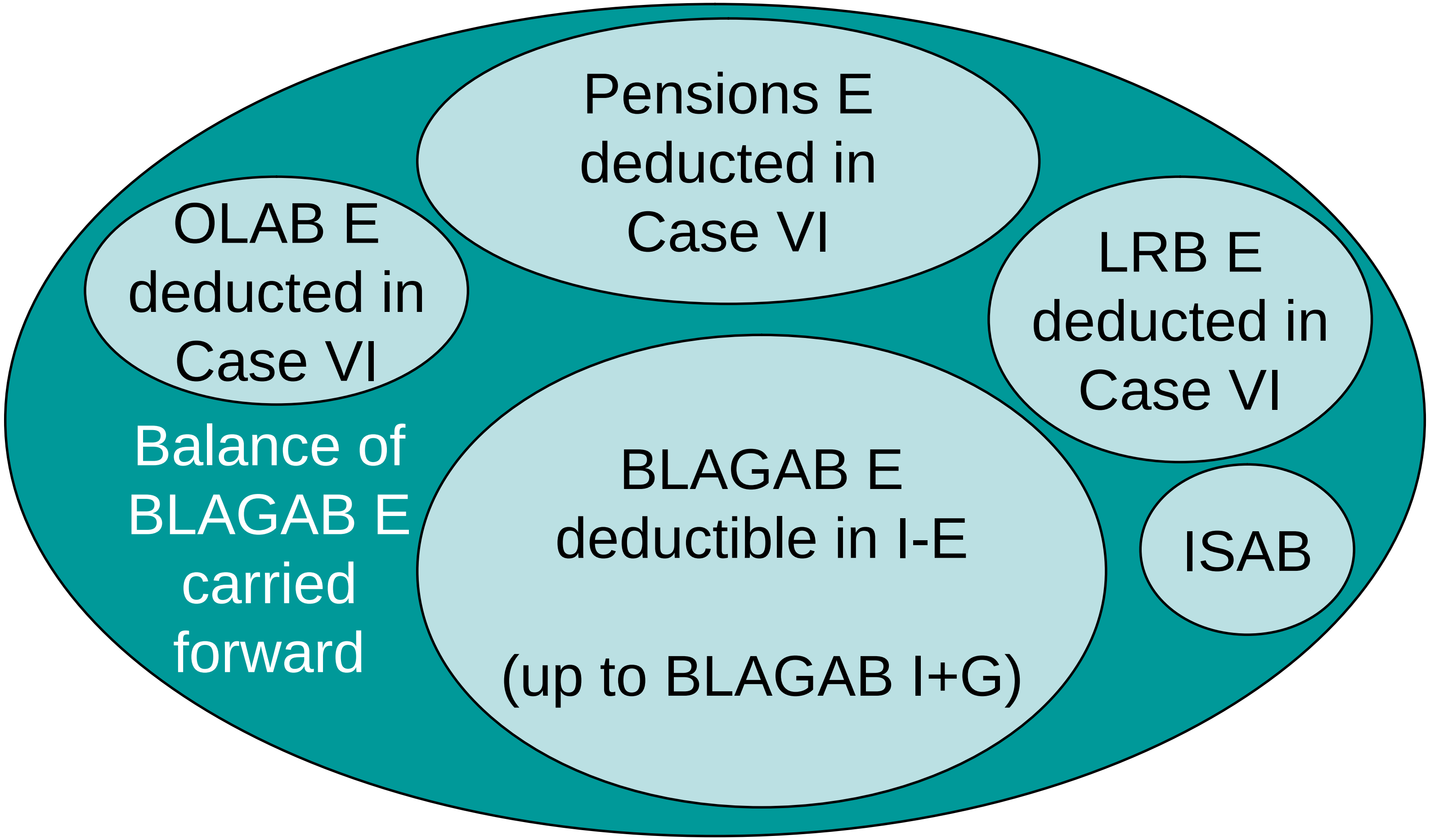
Ring fencing of BLAGAB and Non-BLAGAB losses restricts the extent to which shareholder fund gains can be offset by losses on long term fund assets, and vice versa

Bed and Breakfasting s210B TCGA 1992- restricts losses arising on the disposal and reacquisition of certain securities

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
PB/OLAB/LRB/ISAB Case VI profit		**x**
Less: expenses of management		**(x)**
capital allowances		(x)
Taxable I minus E result		x

Treatment of expenses



Expenses of Management (new s76)

- FA 2004 introduced new provisions setting out how to calculate management expenses
- Expenses must now 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
- Ten step process to calculate the amount deductible in the I-E computation

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

Not in I-E

- PHI case I profits
- Shareholders profits (from Form 16)
- - both these are taxed as shareholders profits

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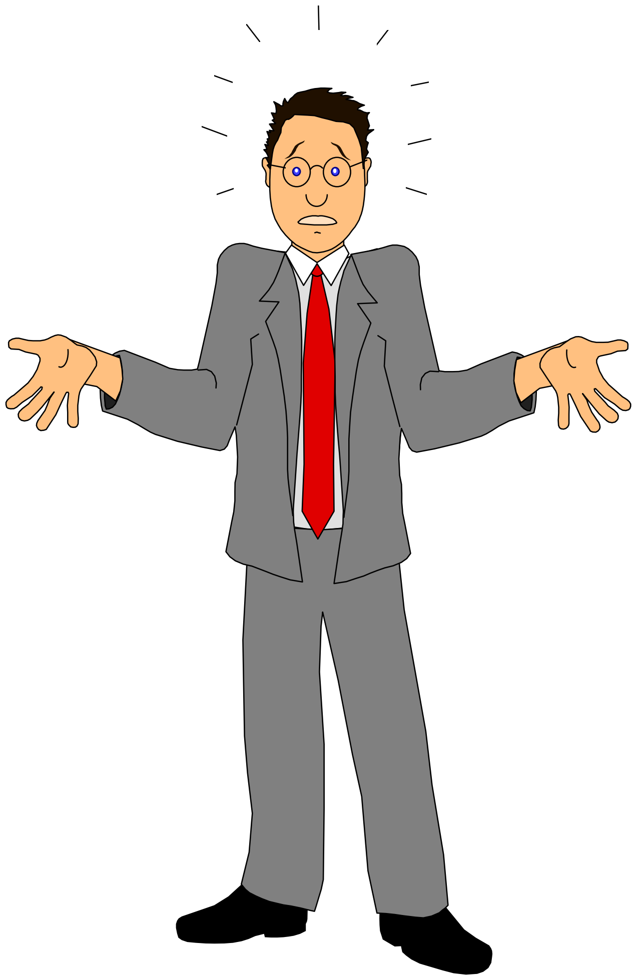
Apportionment

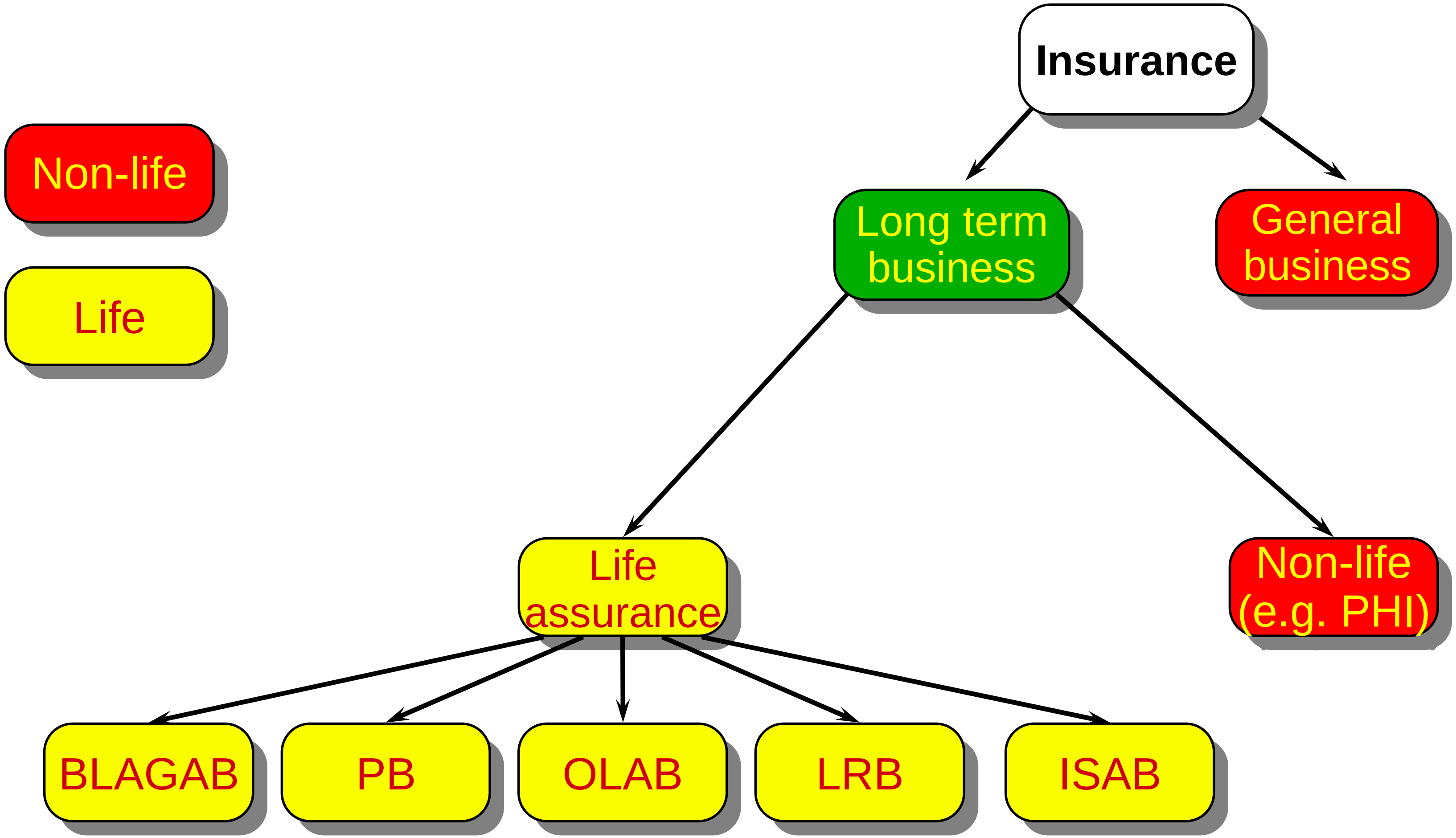
Gavin Coates

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

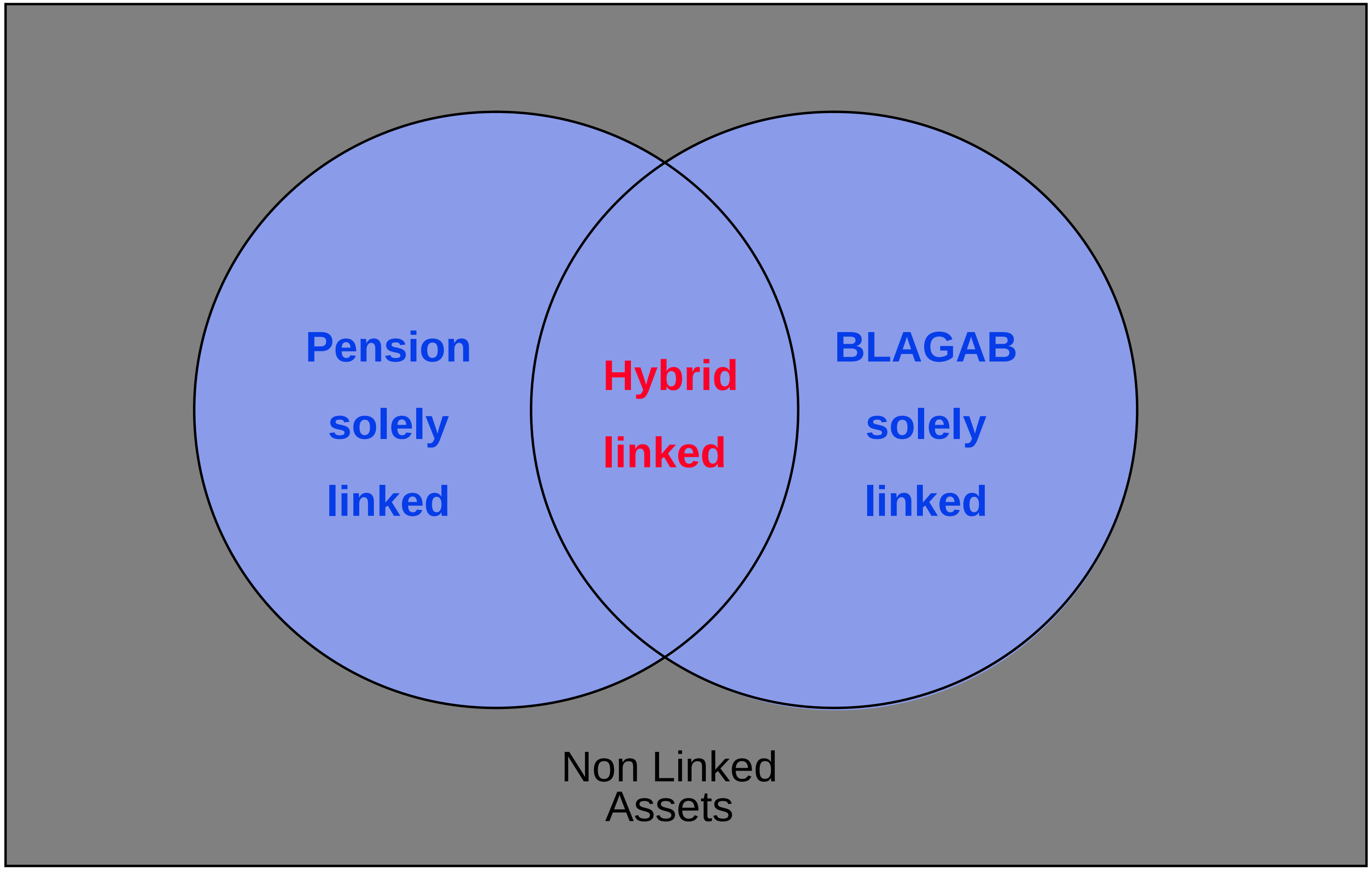


Income & Gains Summary (Non-Profit Office)

	Received or Receivable	FII	Investment Income	Realised Gains	Unrealised Gains
BLAGAB	Received	Exclude	All	Chargeable	-
Pensions	Receivable	Include net	All	All	All
PHI	Receivable	Exclude	All	All	All

Allocation for I minus E purposes

Assets of long term fund



Allocation of income and gains

	BLAGAB	PB
Solely Linked	Actual	Actual
Hybrid Linked	Proportion	Proportion
Other assets	Proportion	Proportion
Total		

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

Hybrid Linked Assets

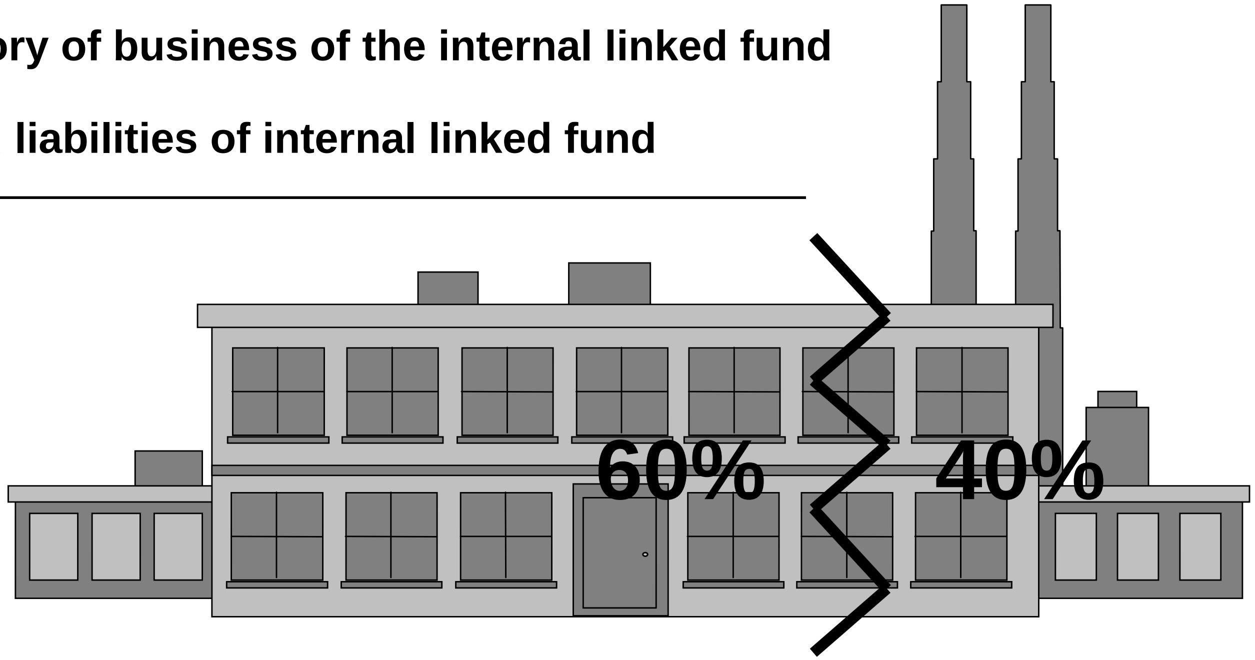
How to allocate

If proportion of value of asset attributed in FSA return to category of business - use that proportion

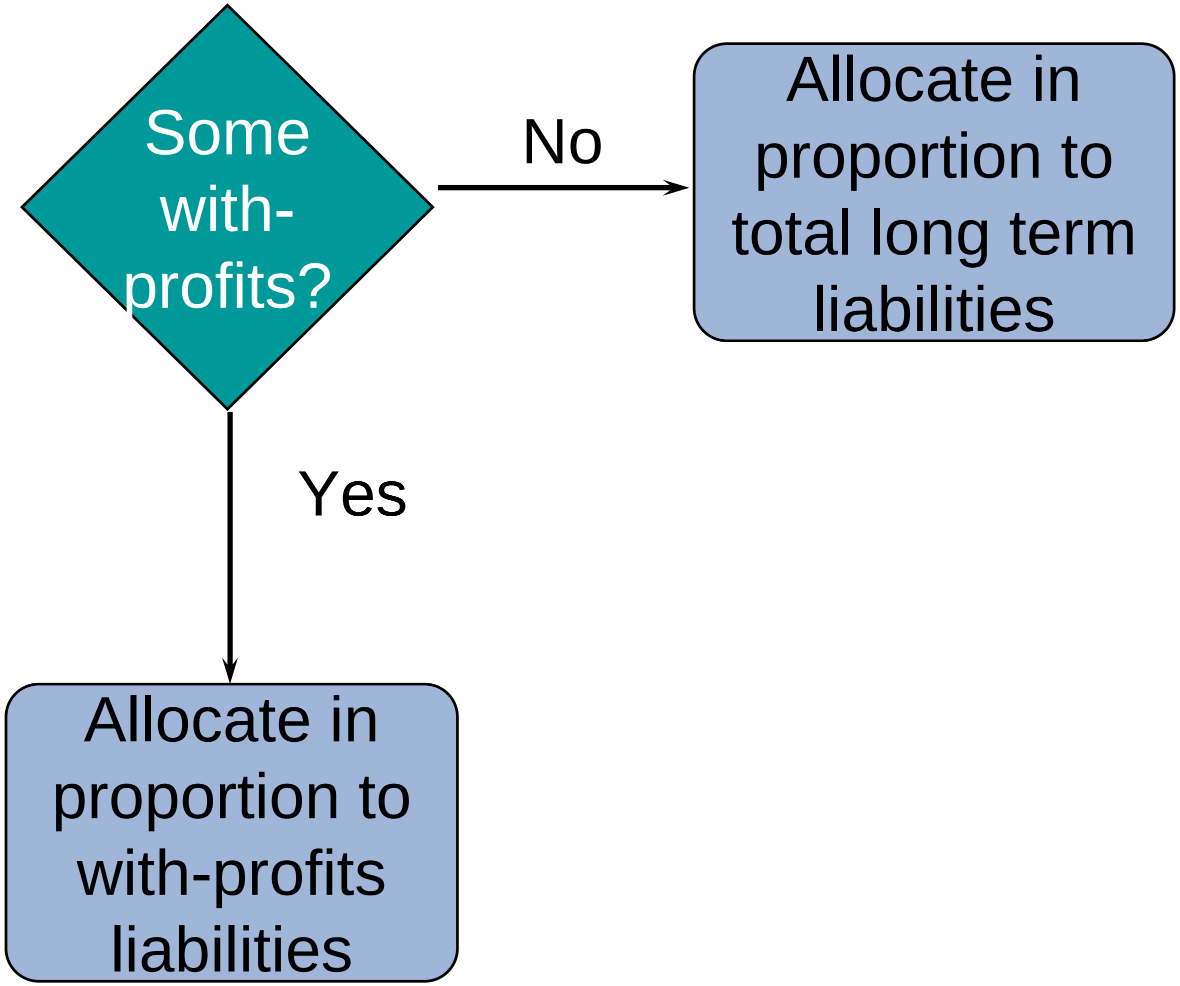
If not use

Liabilities of category of business of the internal linked fund

Total linked liabilities of internal linked fund



Allocation of investment reserve



Fraction (s432A ICTA 1988)

	BLAGAB	PB	Total
	£	£	£
Mean liabilities	X	X	X
Less: mean linked assets	(X)	(X)	(X)
add: mean TIR	X	X	X
	——	——	——
	A	B	C
Percentage	A/C	B/C	100%

Allocation for Case VI computations

s432A vs s432B ICTA 1988

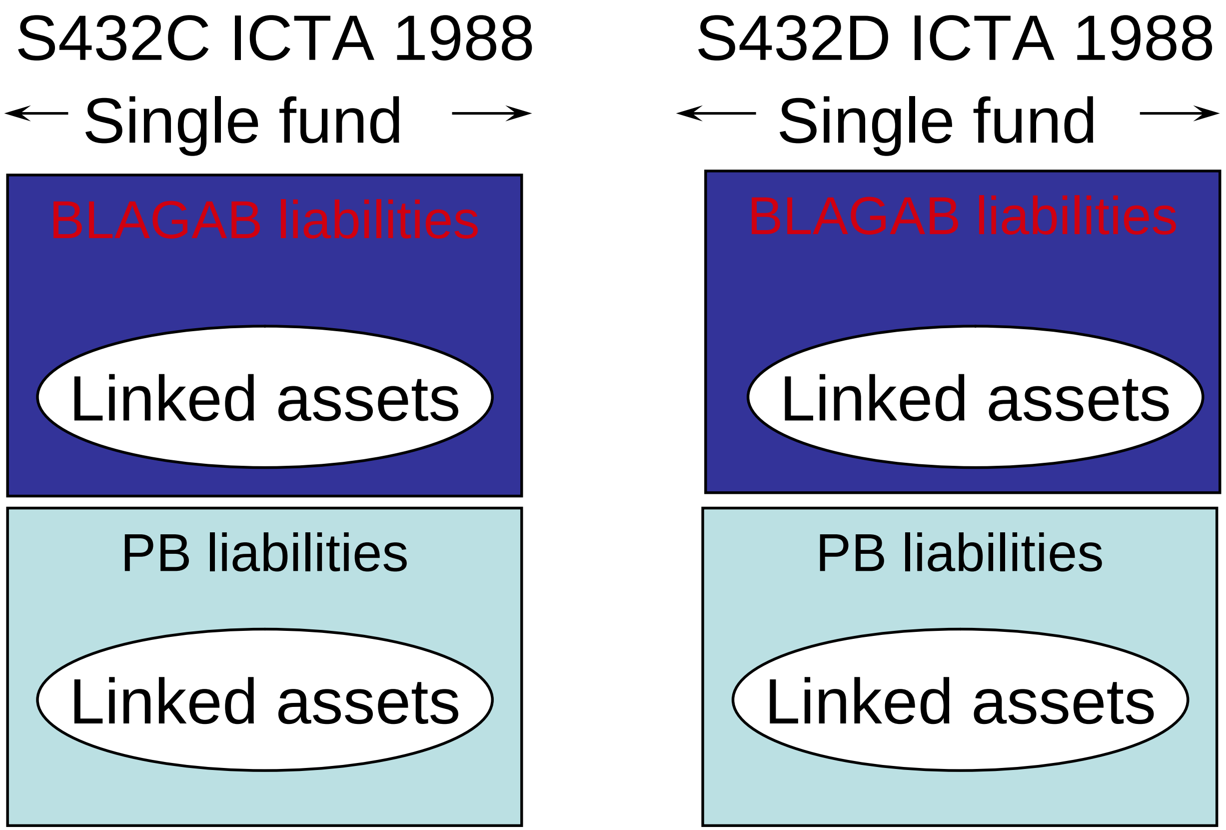
Why not use s432A calculation?

s432A : an allocation of entire investment income and chargeable gains

s432B : an allocation of investment return brought into account

Therefore ignore TIR

s432C & s432D ICTA 1988
non profit business



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)

Fraction (s432 C&D ICTA 1988)

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

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’

Pension 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
Policy holders overseas tax			(X)
Schedule D Case VI profit			**X**

( ) dividend income included net of tax credits

Uses of the allocations

	BLAGAB	PB	LRB	OLAB	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 I

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Notional Case I and Pensions Case VI

Jenny Coletta

NC1 computation

		£	£
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)	
	bonus paid and declared	(X)	
			(X)
Net NCI			X
Add:	tax provision per a/cs	X	
Less:	policy holders tax	(X)	
Shareholders tax			X
Gross NCI profit			X

Surplus arising

	£	£
Liabilities brought forward		X
Premiums		X
Investment income and gains		X
		X
Expenses and interest	X	
Claims*	X	
Liabilities carried forward*	X	
		(X)
Pre-tax profit		**X**
Tax		(X)
Surplus arising (post tax)		**X**

*excluding bonuses

Bonuses

Section 82(2) FA 1989 allows a deduction for amounts allocated to policy holders or annuitants (bonuses declared)

Section 82B allows a deduction for the increase in the amount of the unappropriated surplus which is required to meet the duty of fairness

Policyholders' tax post FA 2003

- Section 82A states that regulations will be laid setting out the way that the amount of policyholder tax to be deducted should be calculated
- Holding regulations are currently in force
- Watch this space .

Shareholders' tax (Method 1)

Net NCI		
(adjusted) net surplus		X
Add shareholders tax:		
tax provision per accounts	X	
less policy holders tax*	(X)	
shareholders tax		X
Gross NCI profit		X

*balancing figure

Shareholders' tax (Method 2)

Net NCI		
(adjusted) net surplus		X
Add shareholders tax:		
tax provision per accounts	X	
less policy holders tax	(X)	
shareholders tax*		X
Gross NCI profit		X

*by deduction

Use of NCI losses

Uses:

- Carry forward under section 393(1) ICTA 1988
- Offset sideways under section 393A ICTA 1988
- Carry back 1 year under section 393A ICTA 1988
- Group relieve under section 402 ICTA 1988

Losses available for surrender (s434A)

NCI loss for the period concerned	x		
Less:			
charges deducted in I minus E computation		(x)	
non trading deficits on BLAGAB loan relationships only	(x)		
(losses on overseas life assurance business		(x)	)
Loss available for surrender		x	

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 NC1 loss utilised exceeds case VI losses, case VI losses of all categories are reduced to nil and management expenses are reduced by the excess

- Where case VI losses exceed NC1 loss utilised, each of the 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

Use of NCI losses carried forward

- HM Revenue & Customs interpretation of section 89 FA 1989
- Changed by FA 2003 schedule 33 para 7

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Interaction between I minus E computation and Notional Case I computation

Notional Case I restriction

Amount of income and gains left in charge to tax must be equal to or greater than the profits of the life assurance business for that period if computed in accordance with the provisions of Schedule D Case I and adjusted for losses

Comparison of profits

NCI profit for accounting period	x	I minus E result for the period	x
Less:			
NCI losses brought forward	(x)	Distributions from UK companies referable to BLAGAB	x
	x		x

I minus E with NC1 restriction - example 1

	£ 000
BLAGAB income and gains	1,750
PB Case VI profit	500
	2,250
Relief for expenses	(1,750)
Taxable I minus E result	500
BLAGAB net dividends	1,000
NCI result	1,000

I minus E with NC1 restriction - example 2

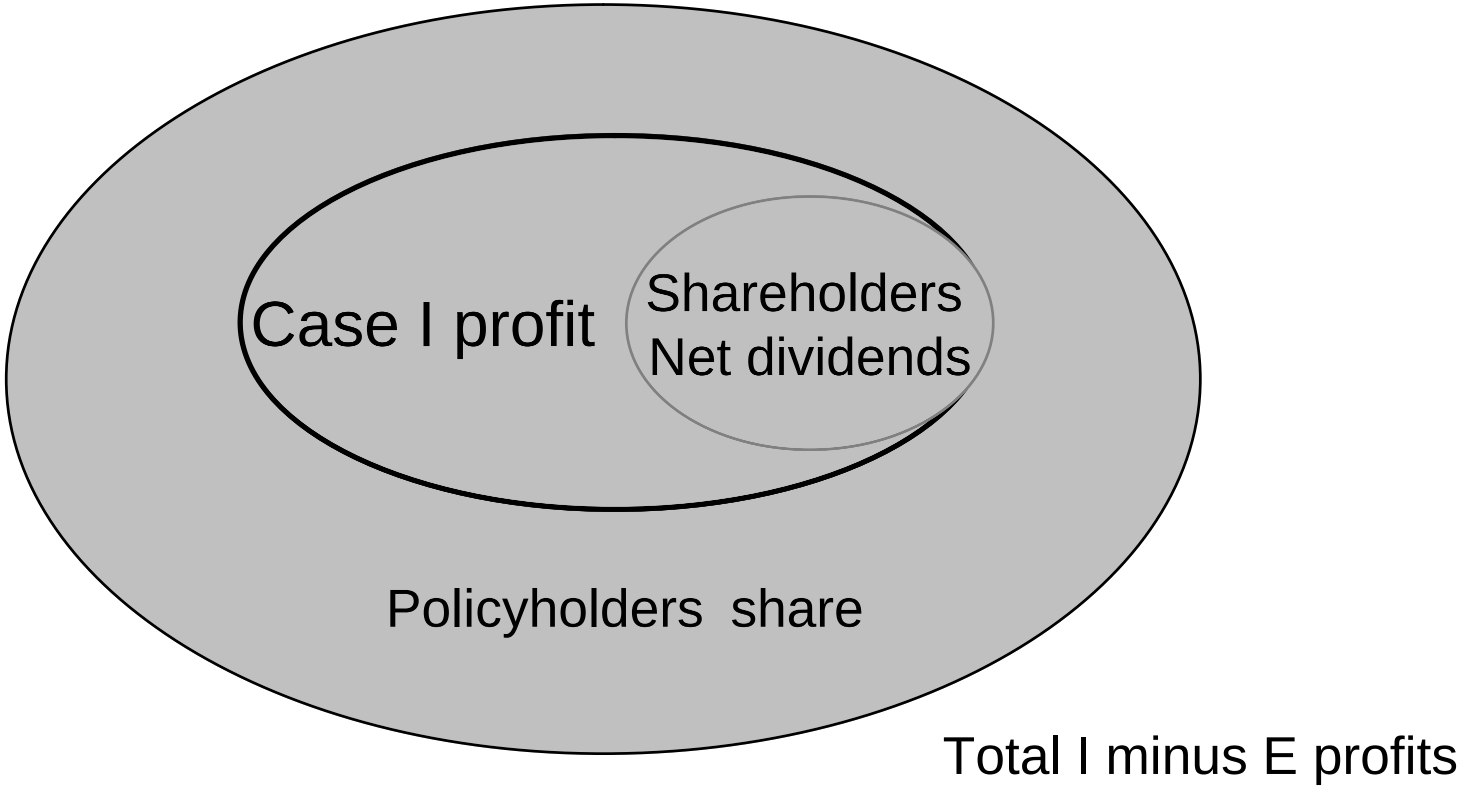
	£000
BLAGAB income and gains	1,750
PB case VI profit	500
	2,250
Relief for expenses	(1,750)
Taxable I minus E result	500
BLAGAB net dividends	250
Required I minus E result	750
NCI result	1,000

Restriction of management expenses of £250,000, so that taxable I minus E result becomes £750,000

Restriction of management expenses

Restriction of management expenses is split between renewal and acquisition by reference to their relative proportions to total current period expenses

Shareholders' and policy holders' profit



Shareholders' share of profits

	£
NCI profit of the company for the period (A)	x
Less:	
Shareholders share of BLAGAB net dividends (A/B)	(x)
	x

A = NCI profit of the company for the period
B = Non premium income and relevant gains over its relevant expenses and relevant interest for the period

Revenue Account - A and B

	Shareholders return (NCI)	Policy holders return	Total
Premiums	x	(x)	
Claims	(x)	x	
Investment return	x		x
Expenses	(x)		(x)
Opening liabilities	x	(x)	
Closing liabilities	(x)	x	
Bonuses	(x)	x	
Surplus	x		
Return to policy holders		x	
			I-E

A

B

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Calculation of tax charge

Calculation of tax charge

Taxable I minus E 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
- Common Principles

- Case I rules - Case VI assessment
- Deduction for expenses and commission
- Deduction for loan relationship trading deficits
- Deduction for capital allowances on management assets but not on investment assets
- Deduction for bonuses
- Deduction for foreign tax re policyholders
- Taxation of investment return - special rules
- Movement in actuarial liabilities
- Ring-fencing of losses

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**

( ) dividend income included net of tax credits

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	apportionment of total expenses incurred
Bonuses	Form 58 of FSA return

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Case Study II

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Tax Modelling and Planning

Paul Turnbull

June 2005

Tax Modelling and Planning

Agenda

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

Tax Modelling

Potential areas requiring tax modelling

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- FSA realistic valuation
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Other Issues

Gordon Gray

Derivatives over shares

- To be treated as loan relationships from budget day 2005 at 3pm
- BUT - Final rules modified to exclude life assurance companies if “approved derivative” for the purpose of Rule 4.3.5 of Integrated Prudential Sourcebook
- No hedging requirement

FA 2005: Shareholder excess assets

- Announced December 2004, debated throughout 2005
- Applies where there has been a formal reattribution of estate assets to the shareholder
- Those assets must be in a non-profit fund for rules to apply
- Deduction for Form 19 line 27 (amount available to support with profit fund)
- Effect is to treat assets as BLAGAB so investment return added to BLAGAB I – E
- Compensating adjustment in Case VI computations
- Effect at policyholder tax rate only
- But compensating adjustment relating to gains is restricted if there is an investment reserve

FB 2006: Non profit investment reserves

- 29 September 2005 announcement
- 3 November retraction
  - Limited to Non profit companies
  - Only movements since December 2003 taxed
- Spreading for that part of investment reserve representing resilience capital
- Adjustments to remove certain capital injections to identify “true” gains for year
- Can elect to remain in regime if borderline

FB 2006: Surpluses of former mutual business

- Restricts planning using surpluses declared prior to demutualisation, in particular:
  - Prevents surplus being used to fund policyholder bonuses
  - Thereby prevents a tax loss arising
- If "policyholder participation fund" (i.e. policyholder bonuses equal surplus arising) then rules should have no effect in most circumstances
- If policyholder bonuses did exceed surplus arising then;
  - Excess would be taxable (i.e. loss would be eliminated)
  - Would also seem to fail definition of policyholder participation fund so further consequences possible
- Funds which are not "policyholder participation funds" appear to be less attractive

Stochastic modelling

- Needs to deal with adverse scenarios (e.g. losses)
- Tax deduction for statutory reserves not realistic reserves
- Therefore may not be appropriate to treat the cost of guarantees as a reserve for tax purposes
- No clear way to tax effect the cost of guarantees
  - Could treat as reduction in investment return
  - Alternatively could split into a fall in income and a (smaller) fall in claims (gives different result as income and claims attract different tax treatment)
  - Interaction with deduction for policyholder tax complicates the analysis so modelling may be required

Grossing of net EEV profit for external reporting

- Current position
  - 30% is common industry practice for UK business
  - EEV standards give little guidance on tax
  - Real rate of tax could be systematically lower that 30% (e.g. shareholder share of UK dividends)

- EEV is still new and therefore evolving. Could grossing up become more scientific?
  - EEV assumptions should, where relevant, be consistent with those used for GAAP (EEV Principles, principle 9)
  - IFRS does not accommodate the use of long term effective tax rates for grossing life assurance profits as UK GAAP did

Emerging issues

- EU law and dividends
- Consultation paper published 15 May 2006
  - Reform of apportionment rules to secure close to 100% allocation
  - Merger of Case VI business and possibly also PHI into single gross roll up category
  - Complete abandonment of I-E does not appear to be a possibility
  - Numerous other suggestions to change technical details