The Actuarial Profession
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Consultation Paper response

HMRC

Consultation on Solvency II and the taxation of insurance companies

June 2010

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2 June 2010

Dear Andy

Consultation on Solvency II and the taxation of insurance companies

Life Practice Executive Committee Tax Working Party response

I enclose our response to the 'Questions' issued by HMRC in a Consultation Document on 10 March 2010 and requesting responses by 2 June 2010.

I have set out the responses and comments from the Tax Working Party ("TWP") which have also been approved by the Actuarial profession's Life Practice Executive Committee ("LPEC"). The questions have been identified by the use of italics. The questions have been answered to the extent we are able to do so in the time available and in the light of our understanding of the position at the time of writing, which will of course continue to develop over time. Where we do not have sufficient knowledge on some of the subject, we have included "no response". This is the case throughout on the general insurance section.

Ultimately, it is the role of the HMRC to propose legislation in order to meet the intentions of Parliament. We will be happy to assist HMRC in this process further as proposals develop and we would welcome the opportunity to discuss the issues with you in a meeting.

Yours sincerely

Paul Turnbull

Chairman of LPEC's TWP

on behalf of the LPEC's Consultation Committee

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The Actuarial Profession

Life Practice Executive Committee’s Tax Working Party

Response to consultation on Solvency II and the taxation of insurance companies

Summary of questions and Working Party response

Chapter 2 A new basis for calculation of trading profits

2.9 Comment is welcome on the starting point for the determination of life assurance trade profits as set out in paragraph 2.8, including whether there might be circumstances where a different figure from the accounts would be more appropriate (for example to take account of exceptional items).

The computation should begin from the profit gross of all tax. There then needs to be a deduction for policyholder tax. Taxable items in the statement of recognised gains and losses or in other comprehensive income will also need to be included.

IFRS accounts are applicable to all public companies and not just insurers and may not reflect the economic reality as well as Solvency II. The standards applicable to liabilities to policyholders are of greatest importance. Contracts within the definition of insurance contracts are dealt with currently under IFRS 4, but this standard is to be replaced with the IFRS Phase II standard for insurance contracts. Other contracts which are regulated as insurance business are treated for accounting as investment contracts under IAS 39.

We understand that although IFRS has some concept of best estimate liabilities and a risk margin, these may be on different bases from those proposed under Solvency II and are inconsistently applied across products. With that in mind, it would seem illogical for a company to assess capital under one regime and pay tax under another that could have a different result. If one chose to tax companies in respect of accounting profits without suitable fiscal adjustments, there is likely to be a disconnect between the timing of tax payments and the emergence of capital available for distribution from the company or for supporting regulatory capital requirements which may lead to increased capital requirements. Tax could therefore cause regulatory insolvency or regulatory difficulty of a viable company contrary to the public interest.

Currently it is unclear how statutory accounts will be affected by the introduction of the Solvency II regulatory reporting regime since there is clearly no current reference in current accounting standards or the IFRS Phase II proposals for insurance contracts to the Solvency II proposals for liabilities to policyholders. We believe that IFRS developments for insurance contracts are more uncertain than Solvency II at this point in time.

2.10 Comment is welcome on the implications for life companies of the ASB’s proposals described in paragraph 2.10, and in particular on the impact of the ASB’s proposed timetable and on the question as to whether there any categories of life company which would not fall to be classified as ‘publicly accountable’.

No response

2.11 Comment is welcome on the potential impact on the accounts of likely changes in technical provisions for solvency purposes. In particular, for companies applying UK GAAP or current IFRS, do you consider that technical provisions in financial statements will need to change to reflect changes in mathematical reserves for Solvency purposes, or could this remain a matter of choice?

No response

2.15 Comment is welcome on whether special transitional measures would be appropriate for the potential subsequent changes in basis outlined in paragraph 2.15(b), or whether the normal rules for dealing with changes in accounting policies would be sufficient to deal with such potential changes.

We would expect a suitable mechanism to be in place to provide a smooth transition.

If there is a life assurance trade profit arising on transition that requires tax to be paid (eg if technical provisions are lower, generating taxable “profits”) but solvency requirements are actually higher, this additional tax will have a further impact on the company’s solvency and may force regulatory intervention against the public interest. Spreading of profits on transition does not solve the current position. The company has to provide deferred tax for the outstanding smoothing payments anyway so there is no solvency relief. Any delay in the tax being brought into charge prevents the tax being used for current losses. The preferred approach would be to have immediate tax but to allow carry-back tax relief for any future losses.
However spreading of profits may help reduce the SCR where immediate losses would be relievable against the future charges to tax.

If there is expected to be a life assurance trade loss, that loss can currently only obtain immediate relief against profits of the same period or by being carried back for one year. Consideration should be given to an extended carry back on transition.

When the basis of reserving for policyholder liabilities was last significantly changed, a spreading of profit recognition for tax purposes was enacted. Since then, the excess life assurance trade profit rules have been enacted and any one-off recognition of taxable profit will result in the taxation of the excess of the trade profit over I minus E and the carry forward of that excess as an expense of management. This provides a smoothing mechanism for companies with excess income as future income will benefit from relief. In contrast, companies with excess expenses will simply have an acceleration of taxable profits. Spreading would not counter this effect. It would merely affect the timing of cash tax payments.

Comment is welcome on the potential impact on life companies of more than one major change in the basis of life assurance trade profits in quick succession, and on ways in which any adverse impact might be mitigated.

A suitable mechanism could couple both changes appropriately to provide a smooth transition. This would be of particular importance if the changes contained contradictory elements. Again, the ability to carry back losses would be the most helpful feature.

2.18 Comment is welcome on the need, and justification, for introducing specific transitional measures to deal with step changes in the values of assets and liabilities, including comment on what specific adjustments might be appropriate.

The recognition of DAC should be handled by the tax rules in section 183 of the Corporation Tax Act 2009. Introduction of realistic liabilities and other matters are addressed through the excess life assurance trade profit provisions. If these are unsatisfactory, some form of spreading may be appropriate. As noted above, these provisions provide a smoothing mechanism for companies with excess income as future income will benefit from relief. Companies with excess expenses will have an acceleration of taxable profits.

The impact of any change will depend on what deductions are available for non-distributable amounts and capital requirements in the life assurance trade profit calculation. The starting point would seem to be the technical provisions or market value of liabilities which are defined under the Directive as the sum of the best estimate liabilities and a risk margin. However, for some products (particularly unit linked products) this could lead to a significant release of reserves to profit though it is not our expectation that any of the capital would be distributable because the overall level of technical provisions plus capital requirements are expected to be much greater than under the current regime. Hence some would argue that the amounts released from technical provisions in this way but reflected in capital requirements should also be allowed for in determining life assurance trade profits. However, this is only an issue if the Solvency II liabilities are adopted for the IFRS balance sheet. To the extent that unit-linked policies are dealt with as investment contracts, the reduction in reserves will not be reflected in IFRS profit, and the acceleration of profit will not arise.

2.20 In what instances might it be appropriate to reconsider the application of general tax rules to life companies?
How might the application of such rules be changed, and why?

The very nature of long term business requires estimates of future experience and if these turn out to be prudent then profits emerge and are then taxed. However if the opposite happens then any losses do not obtain immediate relief, highlighting the disadvantages for companies being taxed on profits based on bare technical provisions derived from best estimates in an industry where assets are held against obligations to the public. It is possible that large unrelieved losses could accumulate whilst tax has been paid on an initially over estimated profit.

Taxation of profits using best estimate provisions would normally produce reasonable taxation in rising markets and over taxation in falling markets. Whilst this might be reasonable in a short term business where contracts are concluded quickly, this is not appropriate for life business where policy contracts are not concluded for 20+ years in many cases.

2.28 To what extent does the FFA/UDS mitigate volatility for with-profits business?
How this might change under IFRS 4 Phase II?

With-profits funds in excess of £0.5bn may lose the Solvency I benefit of the recognition of a significant FFA/UDS and instead there will be a liability in respect of future bonuses and, possibly, shareholders' share of future bonuses. This is currently the case within realistic balance sheets where the liability in respect of shareholder share includes a tax provision which is only payable if and when shareholders profits are paid. Relief will be needed for these liabilities and any remaining amount shown as fund for future appropriations or undistributed surplus. The net result should be the taxation of shareholder transfers from with-profit funds with relief for funds retained for future appropriation. These transfers are smoothed in the same way that bonuses are smoothed over the life of each policy.

2.29 Comments would be welcome on whether there is any justification for mitigating volatility in fee income for linked business following the introduction of an accounts based model for tax purposes.

Volatility in fee income is a second order effect arising from changes in asset values as a percentage of which the fee income is determined. This volatility is inherent in the business model and should not be disregarded in the tax computations. The primary volatility in asset and liability values is fully reflected in the tax computations.

2.32 Are there any reasons why the inherent profit volatility of business with fixed liabilities in a non-profit fund should differ from similar business in a with-profits company?

The answer here depends on the outcome of the illiquidity premium debate for Solvency II purposes. Volatility of non profit business should not be an issue if relevant valuation rules permit the recognition of an investment return premium on assets that are illiquid to a sufficient degree. Business written in the with-profits fund is completely different. A smoothing mechanism there can be provided through the FFA/UDS as the profit from the non-profit business needs to be appropriated in due course between policyholders and shareholders, but there is no certainty that the IFRS approach will persist in giving the same impact as SII.

2.36 How, and to what extent, might tax volatility increase under an accounts based tax regime?

If Solvency II provisions are recognised as a suitable basis for statutory reporting and hence taxation, it is possible that the increased sensitivity to long term assumptions such as persistency and equity market growth will increase volatility of taxable profits. This feature combined with the asymmetric nature of taxation (profits taxed immediately; losses are carried forward) may lead to significant distortion of tax revenues, probably with a net benefit to the Exchequer, especially if losses become orphaned.

For some products it is possible that the technical provisions (best estimate liability including risk margin) will be less than the current statutory reserve. Unit linked policies are likely candidates. Conversely, for other products it is possible that the technical provisions will be more than the current statutory reserve. Annuity policies may have this feature.

The Phase II accounting standard for insurance contracts may change the conclusion here although there is no discussion of this currently. One potential issue may be the recognition of profits at the issue of a policy under Solvency II even though those profits would be extinguished if the policy were immediately surrendered. Such profits recognised under Solvency II may not be distributable and would not be taxable if they were absent from the IFRS balance sheet.

The use of market consistent policy reserves will introduce greater volatility into the profit results. The reserves are calculated using present values of cash flows over periods as long as 40 years or more. However, in the case of market consistent reserves, it will not be possible to use prudential assumptions that can remain stable over long periods. Further, current prudence in the valuation of unit linked business (the reserve is a minimum of the unit fund available on surrender for each policy) may be removed so that this business also becomes sensitive in Solvency II capital reporting to changes in assumed cash flows. Hence the profit result will include the capitalised impact (positive or negative) of assumption changes and changes in initial asset values to the extent that future management charges are determined by the initial unit fund values. The volatile nature of the life assurance trade profit can create distorting effects with the interaction of the I-E result where the tax cash flow impact and potentially the tax result are asymmetrical. The potential scale of this effect may be apparent from reported embedded value movements over 2009 where these are disclosed in the accounts of companies (embedded values are influenced by similar capitalised effects to those that will affect market consistent reserves). For example the disclosed fall in the value of in force asset in the balance sheet of the Lloyds Banking Group in 2008 was over £300m. With this level of volatility, year on year comparison of tax revenues with the current regime will be difficult - companies pay large amounts of tax when markets move positively without the ability to recover prior year tax if subsequent losses occur due to following market falls. It may be possible to consider some system which spreads gains over, say, seven years to avoid this problem.

What might the impact of any such increased volatility be?
What measures might be taken to mitigate any adverse impact?

The principal impacts will be felt by those life offices with significant assets in a non-profit fund not matched to policyholder liabilities. Volatility itself will be mitigated to the extent that

investment value and policyholder liabilities are matched. The excess life assurance trade profit provisions also help to reduce volatility. If profits rise because of increases in taxable gains, both the I minus E and life assurance trade profit comparators will increase and there will be no change to expense relief.
Volatility in the profit may reverse in a subsequent year with no ability to offset losses against prior profits once the general 12 month window for loss carry back has passed. The solution could include spreading of profits over 3 years, as with farming, or by extending the ability to recover prior year tax against current losses

What are the factors that make volatility a particular issue for this industry, given that profits in other sectors, particularly banking, are susceptible to market volatility?

Volatility comes primarily from a mismatch of assets and policyholder liabilities which creates a difference in asset cash flows and liability cash flows over the long life of the contracts. Insurance profits in a year reflect the movement in the capitalised value of all these future cash flows. Profit volatility of banks and other sectors only reflects volatility of cash flows arising in a single year.

2.39 Comment is welcomed on any general principle considered to link taxation of profits to their availability to shareholders.

Current Solvency I calculations defer recognition of profit by requiring companies to hold prudent mathematical reserves for policy liabilities. Since taxable profit is based on the Solvency I result, tax is correspondingly deferred until profit is recognised on a Solvency I basis. Additionally companies are required to hold at least a minimum level of additional capital in excess of the sum of mathematical reserves and other liabilities but these do not obtain tax relief and so such capital is currently accumulated out of post tax sources. This additional capital is small compared to mathematical reserves (typically 4%-5% of non-linked reserves).

We note that HMRC have commented in the past that profits should only be taxed when they become distributable. We would note that capital covering regulatory solvency requirements cannot be regarded as distributable. So if taxable profit is based on distributable profit then this would be based on the change in excess surplus over solvency capital requirements. The Companies Act 2006 uses regulatory surplus on a Solvency I basis without solvency capital requirements as the driver of distributable profits, but this definition will itself need to be revisited for the implementation of Solvency II.

With regards to the Form 40 approach to use of book values and recognition of gains, most companies now recognise all gains and losses as they arise for their non profit business. Exceptions relate to companies that have with-profits funds and a few other exceptions reflecting historical practices or Court scheme requirements. Fundamentally we would regard profits from with-profits business as being the amount that is annually transferred out of the with-profits fund and profits in respect of non profit business as being assessed using mark to market asset values in the profit calculation. In the case of unit-linked business, investment fluctuations would be matched by changes in liabilities to policyholders but for non-linked non-profit business and where additional assets are held in the long-term fund they would be reflected directly in distributable shareholder profits unless they served to augment funds specifically restricted to the support of with-profit business or by reference to Court Schemes governing the distribution of inherited estates. Such restrictions should be recognised in the determination of shareholder taxable profits.

2.42 What circumstances would be considered to render profits “unavailable” to shareholders?
In which of those circumstances is it thought that taxation of profits should be deferred? And why?

In with-profits funds where there are large terminal bonuses then the technical provisions will be greater than statutory reserves as the terminal bonus liability (included in the best estimate liability) outweigh the prudent margins (included in the statutory reserves but excluded from best estimate reserves). However, in funds where terminal bonuses are small the converse may apply. If the full mark to market value of assets is recognised then this is likely to be offset by the liability in respect of future bonuses including that part in respect of future shareholder transfers (if such sum is treated as a liability, though this is not yet certain) if and when those bonuses are payable on exit. Assuming tax is payable in respect of shareholder transfers if and when they are distributed then one would expect minimal impact. However the taxation of any estate in excess of the liability for future bonuses would be uncertain and relief will be needed for these liabilities and any remaining amount shown as fund for future appropriations or undistributed surplus, including any sum which might, in the fullness of time, go to shareholders, until that allocation is actually made.

It is not anticipated that HMRC would intend to subject to current tax the present value of future shareholder transfers in respect of with-profits business or future margins in respect of unit-linked business. If such amounts find their way into profits, for example under IFRS phase II for insurance contracts, fiscal adjustments will be required to reinstate the timing of profits to their actual emergence for the benefit of shareholders.

The additional capital buffer, SCR under Solvency II, is a prerequisite for writing insurance business and therefore has to be set up before any profits can emerge. One might therefore argue that any increase in this capital should be relievable against emerging profits so that over time it will eventually have been set up from pre tax profits and would subsequently be subject to tax as it is released when business runs off. In determining the level of capital to hold, appropriate management actions can be assumed e.g. reduction of terminal bonuses after a large fall in equity markets. The level of SCR stresses are consistent from one company to the next who choose not to use internal models, otherwise there is potential for discretion to be involved. However, we would note the expected policing of assumptions by the FSA.

Any initial capital injection used to support business would not gain tax relief. It is the change in SCR that should be funded out of profits with the benefit of a deduction.

2.44 To what extent is it possible for the FFA/UDS to contain value not wholly attributable to with-profits business?

With-profits policies differ from non profit policies due to their participation in the profits of with-profits funds. UK regulation requires that the with-profits funds are ring fenced so that there is no "leakage" of value out of the funds to the shareholder. The FFA/UDS reflects value that has accumulated in the with-profits funds that is in excess of current expected policy benefit costs and is determined as the balance of the with-profits fund over the value of the policy liabilities as determined using the valuation assumptions.

The FFA/UDS for Realistic Balance Sheet firms differs from the amount disclosed on line 51 of Form 14 of the FSA returns (often referred to as the 'investment reserve'). The FFA is the excess of the market value of the assets of the with profits fund over the realistic liabilities of the policies (simplistically the accumulation of premiums less expenses with interest plus the value of policy options and maturity guarantees). The investment reserve is the excess of the market value of the assets of the with profits fund over the value of assets brought into account in the actuarial investigation, which is often not much higher than the deterministic prudent value of the minimum policy benefits. The key difference is that the FFA is already net of the cost of expected future policy bonuses, whereas the investment reserve includes the value of all future expected bonus allocations plus any additional value but is calculated on a prudent basis. The FFA can exceed the investment reserve and vice versa.

The "profits" in a with-profits fund arise from a range of sources, very often largely from investment performance (which frequently includes material losses as well) but also for example, from mortality profits and expense profits. Additionally there are a number of with-profits funds that have elements of non profit business within the fund. The sources of this business include non profit riders on policies (such as waiver of premium benefits) and annuities arising following the retirement of policyholders who held with-profits pensions savings products prior to retirement. Some funds have more significant accumulations of non profit business, particularly mutual companies where all business is, necessarily, within a with-profits fund. For those with-profits funds that hold non profit business, all the profits on that non profit business form part of the profits of the with-profits funds.

The reported emergence of all profits of a with-profits fund is determined by the board of the company. The profits are allocated between policyholders and shareholders according to each company's articles but are normally allocated 90% to policyholders and 10% to shareholders (if any). Although the board has discretion over the extent of profit to recognise in a year, in most cases the amount recognised is equal to the amount required to pay for the cost of bonuses for the year plus the amount that is consequently due to shareholders. Whilst it would clearly be beneficial to shareholders to release profits as quickly as possible, there are severe consequences for over recognition. In particular, over recognition would remove the buffer of assets that would normally absorb increasing costs of policy guarantees; in circumstances where guarantee costs rise to the extent that a with-profits fund falls into deficit, the shareholder is obliged to make a transfer of assets to the fund to cover the deficit or make alternative provision to cover the deficit.

Hence, the recognition of the FFA/UDS is governed by the obligation to ensure that policyholders are treated fairly (which in turn governs the mix of regular and final bonuses declared), and by the need to manage the fund prudently which constrains the level and mix of regular and final bonuses.

In a number of instances, there are court approved documents ("Schemes") governing the management of with-profits funds. These typically apply to funds that were the subject of a transfer of business including demutualisations. The schemes impact on a range of issues including investment policy, allocation of expenses etc. However, they do not modify the fundamental ring fencing of a with-profits fund. In some circumstances, there are additional obligations imposed such as the requirement to hold additional capital to support the with-profits fund, but to be held in the non profit fund. This is often the source of "investment reserves" in non profit funds.

All the value in the FFA/UDS is attributable to with-profits business (even though it may include margins from non profit business) and is subject to the requirements of each company's articles. It can be retained as FFA or allocated to pay for policyholder bonuses in which event the recognised profit will be sufficient to cover the allocation to policyholders and any corresponding allocation to shareholders. There is no scope for excess funds in a with-profits fund, however described in accounts or otherwise, to be allocated in any other way than is provided for in the normal operation of that fund other than by the means of a reattribution under FSA's process in COBS 20.2.

The above analysis applies to the vast majority of with-profits funds, though some special cases do exist where shareholder rights are determined in a different way which is not directly linked to policyholder bonuses. The principles do still, however, apply.

What mechanisms are used to restrict the use of the FFA/UDS to with-profits business?

The FFA and UDS are measures of value within a with-profits fund. The assets of a with-profits fund can only be used to meet the liabilities of that Fund, or for with-profits business bonuses and for any shareholder allocation according to the established rules for operating that fund. Failure to comply with the FSA Rules that ring fence the with-profits funds is a breach and approved persons and other professionals (including the Actuarial Function Holder and the With-Profits Actuary) would be obliged to "whistle blow" to the FSA.

Standard accounting practice also prohibits the use of an FFA/UDS for non-profits funds. .

How do those mechanisms work where a with-profits fund includes non-participating business?

The existence of non profit business in with-profits funds has no implications for the management of the FFA/UDS. The profits fall to be managed as for profits in the with-profits fund that arise from other sources. With-profits funds which contain significant non-profit business are effectively investing with-profits policyholder funds in the non-profit business. To the extent that they are not allocated under the process of accumulation of premiums less expenses with interest, profits from such business may be allocated to the FFA/UDS pending distribution to the stakeholders of the with-profits fund.

What degree of discretion does a company have in determining the amounts and timing of allocations to the FFA/UDS, and in releasing them to profit, and what constraints exist?

The discretion is around rules for declaring bonuses and the requirements for completing forms. The position for with-profit funds of less than £500m is different since they currently report entirely on a Solvency I basis. The application of the accounting standards to such funds in a Solvency II environment is not yet clear and will depend upon the convergence of UK GAAP and IFRS.

What approach do companies take in deciding what amounts should be added to, or withdrawn from, the FFA/UDS in any period, and how is that process evidenced and documented?

The recognition of allocations to and releases from the FFA/UDS is governed as outlined above. Without an attribution, shareholders are in most funds unable to obtain more than 10% of any released surplus. The current rule requires a valuation of the liabilities to policyholders to be performed in the course of which surplus will be determined for allocation to policyholders and, where relevant, shareholders. The balance unallocated is ascribed to the FFA/UDS. Therefore the FFA/UDS is a balancing item, and active decisions are not taken on it. Rather the value is a consequence of the decisions taken as to bonus payments and shareholder transfers.

2.45 Under a regime based on financial statements, is it appropriate to consider whether PHI profits should continue to be computed separately?

There are merits in respect of simplicity in combining PHI and GRB in a single trade profit computation with the life assurance trade profit provisions applying only to BLAGAB.

2.47 Is there a principled basis for continuing to distinguish life insurance companies from general insurance companies in taxing the income arising on non-structural investments representing shareholder capital?

It is important that structural assets of life assurance companies are not brought into tax on a mark to market basis. Structural assets are structural in that they are held as fixed assets financed by fixed capital. Currently for tax purposes they comprise only insurance dependents. Market value movements in them are not trading profits but unrealised capital movements. Such assets should be taxed only if and when sold. Such treatment is consistent with that applied for general insurance and the generality of trading companies.

2.52 In moving to an accounts based measure should the opportunity be taken to mitigate the commercial impact of the build up of excess expenses? How might this be done?

This is a problem specific to certain companies. Measures in this area impact upon the issue of the future of the I minus E regime and are not considered further here.

There is no issue with allowing a spike to occur in the tax charge due to an increase in profits. If the tax payment were to be deferred, insurance companies would need to provide for the liability in any event. However, the acceleration of tax would be an issue if subsequent losses could not be offset against a prior spike, since this would have been possible had the spike not occurred. Our suggestion would be to allow a carry back of losses to the spike for up to 7 years, possibly on a declining capacity basis.

2.53 What basis should be used to determine the policyholders' share of I-E profits?

Given the feature of I minus E to calculate the sum of both shareholder and policyholder profits, the policyholders' share should continue to be the balance after the shareholders' share of I minus E profits chargeable to corporation tax has been deducted.

2.55 How do the issues discussed in this chapter (and elsewhere in this consultation document) apply differently to mutual companies?
What particular measures may be needed to take account of those differences?

Mutual companies should not pay shareholder tax. There are no shareholders! Axiomatically I-E profit from mutual trading is all policyholder profit.

2.56 To what extent is the Friendly Society sector expected to fall outside Solvency II? What arrangements will be made for regulatory supervision of Friendly Societies outside Solvency II? To what extent are those arrangements expected to mirror the Solvency II rules? What are the implications of the issues discussed in this chapter (and elsewhere in this consultation document) for Friendly Societies?
What particular measures may be needed to take account of those implications?

We expect a significant number of those friendly societies which are exempt from the current EU regime (non-directive societies) to fall within the Solvency II regime, driven by the new regime's liability threshold. Specific measures may need be included for friendly societies, as many of the newly directive societies will need to make significant changes to their operation, though the exemption for mutual trading profits will largely protect them.

2.57 Are there any particular issues, not covered in paragraph 2.58 onwards, arising in respect of apportionments to tax exempt business?

No.

2.60 Will a distinction between LTIF and other assets continue for regulatory and/or accounting purposes? Is such a distinction made and apparent in the financial statements? If not, what should be the starting point for ascertainment of chargeable gains and income referable to BLAGAB?

There is a regulatory distinction between the assets of the LTIF and other assets but there is no such distinction in the Financial Statements. The distinction will certainly need to remain for with-profits funds but it is not clear that the distinction will be retained for non profit funds. This is, however, a UK requirement, and as the Solvency II directives are maximum harmonisation directives there is doubt as to the survival into the new regime, though as the rules derive from a similar principle to the requirements on assets covering technical provisions FSA may be able to retain them. The rules for with-profits funds are, however, more likely to be seen as general good provisions as they are necessary to protect the rights of policyholders.

Are there any other prospective Solvency II or accounting changes which suggest modification of the current apportionment rule would be appropriate? For example, if realistic liabilities reflect terminal bonuses would this allow a simple mean liability basis to be used?

The key determinant here is the deduction of linked assets in the apportionment calculation. If this is to continue, as it should if linked income and gains are to be directly attributed, the inclusion of free assets in the apportionment calculation is essential to ensure that the deduction is from a proxy for total assets. We would however expect free assets to be smaller in value.

2.61 How should the accounts income be allocated between categories of business?

Income and gains from the Financial Statements could either be apportioned using the current rule as described above or directly attributed.

2.62 Is it possible to devise a single apportionment rule for all purposes, and what would it consist of?

Yes. The attempts of the Taxes Acts to modify income and gains to derive taxable profit, including the needs and the floor test, are complex and confusing for what should be a reasonably simple concept. The needs and floor tests also introduce tax cash flows that are counter intuitive, and almost universally ignored by financial technicians in the industry other than the tax managers. This complexity seems to serve no obvious purpose and the unexpected tax flows that can arise generate financial risks that are not understood and consequently not managed. If apportionment is to continue, a single apportionment approach based on the current rules in section 432A ICTA 1988 should suffice for all income and gains of the IFRS income statement for both BLAGAB I minus E and GRB/PHI trade profits.

2.63 Are there any opportunities to extend direct allocation?
Where a company has adopted IFRS or FRS 26 and has classified certain contracts as investment contracts, should the accounts income and gains be allocated directly to investment contract business?
Would the accounting records also allow direct allocation of income and chargeable gains to BLAGAB?

Given the shortcomings in the current rules it may be worth re-expressing our thoughts on these rules that we discussed with HMRC almost 2 years ago. Our thoughts are captured in the attachment "HM Revenue & Customs – Invitation to comment on Taxation of Life Assurance Companies consultative document - Comments from the Actuarial Profession" within the Appendix to this response. However it would be possible to substitute Solvency II technical provisions if necessary. Ideally the actuarial profession would want to allocate assets in accordance with the hypothecation used for assessing realistic reserves. It might however still be necessary to use apportionment for income and gains from additional assets not matched to policyholder liabilities.

The Solvency II proposals strengthen the need for this approach. This is because the Solvency II proposals encourage the mixing of a range of risks within one company; the rationale being that a single company with a single risk has to hold capital to cover stress events on that risk, where as a company with several risks that are not related need only hold capital for one of those risks happening at a stressed level (with other risk contributing but not at the fully stressed level). The combination of risks allows the holding of less capital in total than if those risks were held in separate companies. Further internal reassurance is not treated sympathetically so that the cedant will have to hold additional capital to cover the risk that the reassurer may default.

Currently it is common to ensure that pension annuity business is held in a separate company from with-profits business in order to secure a tax treatment of investment income that reflects the product design and the reality of the asset hypothecation that is intended and is fully appropriate. In a Solvency II environment there will be a dilemma between retaining the separation and incurring the cost of raising additional capital, or collapsing corporate structure to minimise capital in order to avoid the inappropriate tax cost. We would suggest that the conflict between tax efficiency and prudent risk management should be removed, particularly in these capital constrained times.

Chapter 3 General insurance issues

3.5 How effective are the current CER rules in helping to smooth the profits of the most volatile lines of business?

Given that under Solvency II CERs are no longer expected to be required, how will insurers react commercially? Are there alternative measures which insurers could, or will have to, take to spread the effect of major claims "spikes"?

What would be the impact if there were no replacement mechanism?
If a replacement system were to be implemented, what should it look like?

What administrative and compliance costs would be involved for business in administering any stand-alone replacement system?

If no replacement system were to be implemented, on what basis should any built up reserves be released to tax?

No response - GI

3.*9 What is the expected impact on tax of changes to general insurers' technical reserving under Solvency II?*
If technical reserves in the financial statements follow Solvency II, how, for general insurers, should any step change on transition be dealt with for tax?

Bearing in mind that it is the change in reserves rather than their overall level which impacts on profits in any period, how much would ongoing reduced levels of technical reserves affect the results of general insurers and how could any effects be mitigated?

No response - GI

Chapter 4 Potential wider reform of the I-E Regime

4.12 The Government would welcome further discussion of the issue with the industry.

The I minus E system integrates both the taxation of the shareholder and that of the policyholder personally. Major reform of the I minus E system should therefore only be conducted in the context of a wider review of the taxation of retail savings products including bank deposits and collective investment schemes.

At present we believe the current approach of I minus E is reasonable and has been for a large number of years. Whilst a major review may be undertaken in the medium term, it is not a requirement for the implementation of Solvency II and would be likely to proceed to a different timetable, not least the timescales for implementation are fast approaching and any additional workload would not be welcomed at this late stage if it is unnecessary.

The Condoc notes the complexities of the current I minus E system and hints at a disaggregated approach (such as “Schedule X”) to the taxation of policyholders’ profits and shareholders profits.

If Schedule X were introduced the key impacts for life companies might be:

- significant financial impact on profitability of in force protection and savings business
- possible reduction in the scope to utilise existing unused tax losses;
- new entrants into the UK protection business market (particularly overseas companies) who were previously deterred by not having a large UK savings book to access the tax synergies;
- upward pressure on new protection premiums caused by loss of tax relief, only partially offset by downward pressure if new entrants significantly increase competition;
- a changed competitive landscape for life savings products compared with other products, e.g. collective investment schemes;
- potential treating customers fairly (“TCF”) consequences in respect of existing savings policyholders; and
- systems implications to ensure compliance with the new regime.

Further, moving to a Schedule X basis would introduce significant new transitional complications that could not realistically be resolved either for legislation to be enacted or for consequential systems changes to be implemented by the end of 2012.

We would expect such a change would need to be grandfathered to avoid some of the more important consequences above on company value, to existing business and impacting policyholders' payments risking not treating customers fairly.

A concern for HMRC in connection with the current regime may be the tax synergy that arises where protection and savings (life) businesses are written in the same company. Typically protection business generates more E than it does I and that excess can in the I minus E calculation be offset against the savings business income (policyholder profits that the revenue wishes to tax), reducing the overall I minus E result and hence tax payable. Companies that cannot secure this tax synergy are placed at a competitive disadvantage when writing protection business. HMRC might see Schedule X as removing this disadvantage and generating more tax for the Exchequer. An alternative approach might be for HMRC to treat new protection business on a gross basis within the current regime – this would alleviate much of the concern over the consequences of wholesale replacement of I minus E whilst removing the potential distortion in the protection business market.

Appendix

The Actuarial Profession
making financial sense of the future

consultation response

HM Revenue & Customs – Invitation to comment on Taxation of Life Assurance Companies consultative document

Comments from the Actuarial Profession

September 2007

To: **HMRC** Date: **12 September 2007**

From: **The Faculty and Institute of Actuaries Tax Working Party**

Copies: **Faculty and Institute of Actuaries Life Board**

Response to consultation by HMRC on taxation of life assurance companies

Background

1 The Faculty and Institute of Actuaries Tax Working Party has prepared the following submission to HMRC following consultation with the Life Board of the Faculty and Institute of Actuaries.

2 The submission was initiated by the consultation document issued by HMRC in May 2006 on the subject of taxation of life assurance companies. Although the closing date for submissions has expired, we also note that there has been a subsequent request from Jeremy Tyler in an e-mail dated 22 December 2006 entitled "(1) Gaps in HMRC understanding (2) And finally..." which extended an open invitation to submissions commenting on the taxation of life assurance companies. This submission is a response to the later e-mail. Further, we understand that a number of issues raised by the consultation are still under development and so this submission may assist with that ongoing consultation.

3 The Actuarial profession has not normally contributed to such discussions as they tend to be focused on specific clauses in legislation and this is probably outside the profession's area of expertise. However Jeremy Tyler's e-mail clearly indicated a desire for a better understanding of issues faced by the insurance industry so this note considers some of the objectives of the taxation approach and the implications of the huge developments in financial reporting and management of life companies. These developments may provide an opportunity to remove a number of the artificial features of the current taxation approach and the likely distorting effect on profitability. Such a move may also have benefit for the actuarial profession since these distorting effects are difficult to model and defy intuitive understanding.

4 In relation to the May 2006 consultation document, we would add that we are broadly supportive of the objectives of that consultation.

5 A Glossary is appended to this paper.

Summary

6 The comments in this note may be summarised as follows:

- We suggest that the allocation of income between tax categories could better reflect the actual allocation used to determine policyholder benefits. We set out below some high level comments on how recent developments should facilitate this approach.
- We would encourage all activity to simplify the tax legislation which has recently suffered from a number of complex anti avoidance measures and also contains obscure features that can have non intuitive tax consequences.

Allocation of investment income between the various tax categories - background

7 For some considerable time, the approach to the inclusion of income (including gains) in the tax calculation has required the apportionment of income between tax categories using mean mathematical reserves for the apportioning. Recently, changes have been introduced to increase the investment income allocated to BLAGAB. However, this whole approach is necessarily approximate and in most, probably all, cases is inconsistent with the allocation of income for the purposes of bonus allocations.

8 The May 2006 consultation over the allocation of investment income between tax categories has focused on achieving an effective taxation of 100% of the investment income and on effectively taxing income on assets in long term funds attributed to shareholders on a received basis (as for BLAGAB). It is perhaps surprising that the current regime omits some investment returns from a tax charge for some companies and double taxes investment returns in other companies.

9 Additionally this allocation approach leads to taxation treatment of income being inconsistent with benefits paid to policyholders. The reasons include:

- Income is allocated, for tax purposes, in proportion to regulatory reserves and this is currently the continuing expectation subject to some superficial modification. However, with-profits policies with high guarantees may have relatively high regulatory reserves and with-profits policies with comparatively modest or no guarantees will be under represented in this approach. Consequently, the current income allocation reflects the degree of policy guarantee rather than an assessment of the asset value that is attributable to a with-profits policy.

- Within a reasonably large long term fund there is likely to be extensive hypothecation of assets to groups of policies and the complexity of such hypothecation is likely to continue to develop. For with-profits business, investment income on these hypothecated assets will be used to roll up a form of shadow account that is used to determine bonuses, and ultimately, policy payouts. Such shadow accounts are likely to be specific to particular policy or product groupings and amounts of loan relationship assets and equity type assets will vary between accounts. Hence the allocation of capital gains, loan relationship income and dividend income are likely to differ markedly from that assumed in the current tax apportionment rules (where there is no recognition of this differential hypothecation). A particular example would be pension annuities in a with-profits fund where the hypothecation would be 100% loan relationship assets whereas the current allocation rules would inappropriately allocate equity assets that may be hypothecated to BLAGAB with-profits business, with a compensating misallocation of loan relationship assets and hence taxable income to the BLAGAB business.

10 The current system has encouraged companies to establish subsidiaries to write certain lines of business where otherwise the allocation of investment income would be unrealistic. This gives rise to substantial additional governance-type expenses. Furthermore, this solution is not generally feasible for with-profits business because of the difficulty and undesirability of determining a "one-off" apportionment of the fund's free assets.

11 Although not necessarily relevant, it is interesting to note that the current income allocation for tax purposes necessitates two asset allocation calculations, one for modelling tax charges and one for modelling the accumulation of the shadow accounts. This significantly increases run times for the stochastic models used to calculate the “realistic balance sheet” results and also requires the calculation of regulatory liabilities which are not otherwise required for the realistic balance sheet results.

12 Income allocation for unit linked business is consistent with the allocation used to determine policy benefit and income attributable to other non profit business could follow the hypothecation approach suggested for with-profits business.

Allocation of investment income between the various tax categories - suggestion

13 We would suggest that the method of allocation of income used by each company for bonus declaration purposes on its with-profits business should be used as an alternative and simpler approach to the current apportionment rules required by tax legislation.

14 This would effectively tax BLAGAB business on the income less expenses as allocated to policyholders in the policy benefit payments and that investment income on gross roll-up business should remain untaxed to the extent to which it is ultimately paid to gross roll-up policyholders. This would seem to be an appropriate approach for the taxation of life assurance business for HMRC.

15 It is now likely that there are significant controls around this process because companies are required to report on the success with which payouts on with-profits business reflect the policy share of the shadow account. This report is provided annually by the with-profits actuary and is required by the FSA’s conduct of business rules. Further the determination of the “realistic balance sheet” result published in the FSA Returns (which use the shadow account approach) is subject to audit and the opinion of an independent “reviewing actuary”. The governance requirements to enable this reporting and other recent industry developments has lead to the development of significant sophistication in the allocation of investment returns within many life companies and it would seem appropriate to use this functionality for tax purposes.

16 This approach would also logically extend to income that relates to provisions for all non profit liabilities and provisions for policy options and guarantees. All such provisions will also be allocated matching assets for the purposes of allocating income across the business of the long term business fund(s).

17 The allocation of management expenses between BLAGAB and gross roll-up business is already permitted on a best view basis subject to scrutiny by tax inspectors. It would seem likely that a similar approach could be used for the allocation of investment income. Further, this approach could be structured to achieve the desired taxation of 100% of investment income.

18 Again, although not strictly relevant, the use of this hypothecation in the allocation of investment returns for tax purposes would be beneficial in the modelling environment. The shadow account approach to the hypothecation of assets is already modelled in the stochastic modelling in order to ensure that the modelled policy payments are materially correct. The tax calculations already assumed for roll up of these shadow accounts would become appropriate for the main company level calculation of tax without the need for extensive additional and complex modelling.

19 The above description of the allocation of income for bonus purposes would be reasonable for most of the larger life companies that report on a realistic basis to the FSA. However, for a number of smaller companies and Friendly Societies that have with-profits liabilities of less than £500 million, such functionality is not required and may not exist. Hence it would be appropriate to provide for such cases. This is already reflected in FSA Rules whereby such companies are excused the onerous "realistic basis" reporting requirements, subject to adequate demonstration of capital adequacy. It should be possible to develop a similar approach for tax purposes for these companies; presumably allowing a move to an approach consistent with the above discussion or permitting retention on the existing system for companies with less with-profits business.

20 Companies that have only non profit and unit linked business should have no issues in relation to their unit linked business. Taxation of their non linked business may benefit from using a similar approach to with-profits business to reflect the likely rigorous controls over the matching of assets and liabilities.

21 We note that there is also ongoing consultation on the taxation of income from assets representing inherited estates and on income from other assets held in excess of liabilities within long term business funds. We would expect the taxation of such income to require suitable apportionment although, if the above suggestion is adopted, the amount of such excess assets would logically relate to the liabilities as determined using the shadow accounts and the related provisions for policy guarantees and options.

Reduce complexity and increase certainty.

22 Simplifications of the tax regime and removal of esoteric taxation features are to be welcomed and encouraged. Complexity and non intuitive tax rules are likely to expose the industry to risk of errors in both actions taken and financial reporting.

23 Further, we would suggest that tax rules should not adversely influence the prudent and appropriate financial management of life assurance business.

24 We would accept that companies should seek specialist tax advice for actual transactions, but it would be inappropriate to expect routine modelling for financial reporting to anticipate illogical tax features that may occur in for example modelling of stressed conditions (required for capital adequacy assessment).

25 There have been examples in recent years whereby legislative changes have targeted perceived abuse but have had wider implications.

26 Consequently we welcome the initiatives in the May 2006 consultation document that seek to reduce complexity though we would also suggest that future consultation is sufficiently broad that all implications of legislative changes are identified. To this end we also welcome the recently introduced practice of providing helpful and clear explanatory notes with draft new legislation and would suggest that this practice is comprehensively applied.

The Faculty and Institute of Actuaries Tax Working Party

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Appendix

Glossary

Term or Acronym	Description
BLAGAB	Basic life assurance and general annuity business. This is a category of business defined in the taxes acts and includes mortgage endowment business, term assurances and purchase life annuities.
Gross roll-up business	The tax category introduced by the 2007 Finance Act amalgamating the tax categories of pension business, OLAB (overseas life assurance business), LRB (life reassurance business), ISA and Child Trust Fund.
“Realistic” valuation or results	The phrase “realistic” refers to the use in FSA Rules in relation to the “realistic” valuation of with-profits life business, whereby long term liabilities are determined in relation to asset shares plus any associated guarantee costs, typically involving the use of stochastic modelling. The realistic capital assessment may be referred to as the Peak 2 capital assessment.
“Regulatory” valuation or results	The phrase “regulatory” refers to the use in FSA Rules in relation to the regulatory valuation of both with-profits and non-profit life business, whereby long term liabilities are determined by discounting future liabilities at a specified rate of interest. The regulatory capital assessment may be referred to as the Peak 1 capital assessment. This is the approach to actuarial valuations that has been used historically although there have been changes to the detail of the approach over time.
Reviewing actuary	The reviewing actuary makes a private report to a firm’s external auditors on the valuation results presented in the FSA Returns. The management of shadow accounts would be within scope of this report since the values of shadow accounts are material to the realistic valuation results.
Shadow account (referred to as “asset shares” by the actuarial profession)	A notional account consisting of the accumulation value of premiums less expenses and costs, accumulated at the rate of investment return (net of tax) earned by the relevant fund or part fund managed by the life company. Typically each life company describes the rules that it applies to the calculation of asset shares in the Principles and Practices for Financial Management (PPFM) that it is required to publish.
With-profits actuary	The with-profits actuary is required under FSA Rules to advise a firm’s management in relation to the exercise of discretion and the fair treatment of policyholders. This would include assessing the management of shadow accounts in accordance with the PPFM. The with-profits actuary would expect to report, to policyholders, any material failures in PPFM compliance.