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2008 Life Convention
9-11 November 2008

Life isn't meant to be taxing

Update from Tax Working Party

Trevor Fannin
Matthew Little
Matthew Taylor

Agenda

- Reprise of life office taxation
- Why do HMRC not respect the matching of assets and liabilities?
- Is it equitable to charge CGT to policyholders? Review of recent HMRC changes
- Taxing overseas equity dividends similarly to UK equity dividends
- Taxing all forms of financing (both reassurance and non reassurance)
- Review of other recent consultation and budget announcements
- Appendix: Glossary

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Overall I-E for a proprietary is…..

"BLAGAB I-E" + "GRB Case VI profits"

"BLAGAB I-E"
- Income
  - Unfranked investment income (UK dividends ignored)
  - Indexed realised gains (net of losses)
  - Deemed disposals on all collective investment schemes (spread over 7 years)
  - Capital increases in loan relationships
- Expenses
  - Renewal expenses
  - Acquisition expenses including renewal commission (spread over 7 years)
  - Unrelieved expenses brought forward ("XSE")
  - Capital decreases in loan relationships
  - Income content of general annuities

GRB Case VI profits
- Case VI profits are effectively shareholder profits, as policyholder returns do not get taxed.

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Does BLAGAB I-E makes sense?

I-E tax is a tax on **profits**
It taxes profits made by shareholders **and** profit made by policyholders
Proof
Revenue Account

Premiums	P	
Income + gains	I	
Expenses	E	
Claims	C	(including increase in reserves)
Pre tax profit	SP	(shareholders profit)

SP = P + I – E – C = I-E – (C-P)

Policyholders profit (PP) is the excess of claims received over premiums paid and hence PP = C-P
thus
SP = I-E – (PP)
I-E = SP + PP

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NC1 Test

- HMRC want to tax SP at 28% and PP at 20% hence they split the I-E into two components
- Shareholders share of I-E is NC1 profits
- NC1 is also used as the minimum value for the I-E. When the minimum applies, the excess of NCI over I-E (incl UK dividends) is deemed to be additional income,
- …. but that excess and any E unrelieved in I-E is carried forward for possible relief in future years

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How is income apportioned?

- Need to allocate non-linked investment return between life products and pension products (direct allocation of unit fund revenues for linked business)
- Currently, for non-linked business, one done at company level and one at fund level and as a result
  - The apportionment rules are complex and are currently the subject of consultation to see if this anomaly can be removed
  - Apportionment is based on Mathematical Reserves for non linked business
  - **The taxation of income has no regard to the allocation of the income to policyholders for non linked business**
  - **The sum of the resulting two amounts apportioned is higher or lower than 100% of investment return in year**
  - Does it have to be this hard?

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Apportionment - example

With-profits fund with:

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

Assets

- £100m of bonds matching annuities – 5% return
- £200m of equities matching with-profits – UK dividends 2%, growth 5% (RPI 3%)

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Apportionment - example

Intended allocation	Gilt Return	Equity Return	Tax
£100m of BLAGAB With-Profits	0.00	7.00	0.40
£100m of GRB With-Profits	0.00	7.00	0.00
£100m GRB annuities	5.00	0.00	0.00
Total			0.40

This is the way you may allow for it in pricing, reserving and bonus setting

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Apportionment - example

Actual allocation	Gilt Return	Equity Return	Tax
£100m of BLAGAB With-Profits	1.66	4.67	0.60
£100m of GRB With-Profits	1.66	4.67	0.00
£100m GRB annuities	1.66	4.67	0.00
Total			0.60

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Apportionment – alternate example

Intended allocation	Gilt Return	Equity Return	Tax
£100m of BLAGAB With-Profits	0.00	7.00	0.40
£100m of GRB With-Profits	0.00	7.00	0.00
£100m BLAGAB Non-Profit	5.00	0.00	1.00
Total			1.40

This is the way you may allow for it in pricing, reserving and bonus setting

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Apportionment – alternate example

Actual allocation	Gilt Return	Equity Return	Tax
£100m of BLAGAB With-Profits	1.66	4.67	0.60
£100m of GRB With-Profits	1.66	4.67	0.00
£100m BLAGAB Non-Profit	1.66	4.67	0.60
Total			1.20

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Mean funding

S432A (calculated across the **whole company**)

BLAGAB income = BLAGAB unit fund income
+Non linked income x (BLAGAB liabs less BLAGAB linked assets + BLAGAB FA)
(Total liabilities less linked assets + Total FA)

GRB income = GRB unit fund income
+Non linked income x (GRB liabilities less GRB linked assets +GRB FA)
(Total liabilities less linked assets + Total FA)

Free assets (FA) amount split in proportion to with-profits liabilities

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Mean funding

S432C (calculated separately for **each fund**)

BLAGAB income = BLAGAB unit fund income
+Non linked income x (BLAGAB liabilities less BLAGAB linked assets)
(Total liabilities less linked assets)

GRB income = GRB unit fund income
+ Non linked income x (GRB liabilities less GRB linked assets)
(Total liabilities less linked assets)

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Mean funding

S432E (calculated for **each with-profits fund**)

- Case VI Investment Return is greater of:
  - The amount needed to provide profits to cover bonus payments and shareholder transfer
  - The‘floor’

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Mean funding

Overall I-E includes BLAGAB I (S432A) plus GRB Case VI GRB I (S432C)

So non-linked (NL) income included in taxable profits is:

$$\text{BLAGAB NL income} = \text{NL income} \times \frac{\text{(BLAGAB liabilities less BLAGAB linked assets + BLAGAB FA)}}{\text{(Total liabilities less linked assets + Total FA)}}$$

$$\text{GRB NL income} = \text{NL income} \times \frac{\text{(GRB liabilities less GRB linked assets)}}{\text{(Total liabilities less linked assets)}}$$

However GRB Case VI includes GRB I (S432E) for with-profits.

432A: an allocation of entire investment income and chargeable gains
432C/E: an allocation of investment return "brought into account"

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Income apportionment >100%

			With profit fund BLAGAB	With profit fund GRB	Non-profit GRB	Total	
Liabilities			100,000	100,000	100,000	300,000	
Free assets				10,000	5,000	15,000	
Total assets				210,000	105,000	315,000	
Investment Return				5.0%	5.0%		
Income on assets matching liabilities				10,000	5,000	15,000	
Income on free assets				500	250	750	
Total income				10,500	5,250	15,750	
Free assets			7,500	7,500		15,000	
Proportions for allocating income (S432A)		Life	34.1%			100%	
		Pensions		34.1%	31.7%		
Proportions for allocating income (S432C)		Life					
		Pensions			100.0%		
Income allocated	S432A	**Life**	**5,375**	**-**	**-**	**5,375**	
		Pensions	-	5,375	5,000		
Income allocated	S432C	Life	-	-	-	-	
		Pensions	**-**	**-**	**5,250**	**5,250**	
Income allocated	S432E	Life	-	-	-	-	
		Pensions	**-**	**5,375**	**-**	**5,375**	
Income used in tax	Life S432A		5,375			5,375 }	
	Pensions S432C/E			5,375	5,250	10,625 }	**16,000**
Income left out of account					-	**250**	

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Income apportionment = 100% (influenced by allocation of FA)

			With profit fund BLAGAB	With profit fund GRB	Non-profit GRB	Total	
Liabilities			100,000	100,000	100,000	300,000	
Free assets				15,000	-	15,000	
Total assets				215,000	100,000	315,000	
Investment Return				5.0%	5.0%		
Income on assets matching liabilities				10,000	5,000	15,000	
Income on free assets				750	-	750	
Total income				10,750	5,000	15,750	
Free assets			7,500	7,500		15,000	
Proportions for allocating income (S432A)		Life	34.1%			100%	
		Pensions		34.1%	31.7%		
Proportions for allocating income (S432C)		Life					
		Pensions			100.0%		
Income allocated	S432A	**Life**	**5,375**	**-**	**-**	**5,375**	
		Pensions	-	5,375	5,000		
Income allocated	S432C	Life	-	-	-	-	
		Pensions	**-**	**-**	**5,000**	**5,000**	
Income allocated	S432E	Life	-	-	-	-	
		Pensions	**-**	**5,375**	**-**	**5,375**	
Income used in tax	Life S432A		5,375			5,375 }	
	Pensions S432C/E			5,375	5,000	10,375 }	**15,750**
Income left out of account						-	

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Income apportionment < 100% (distorted by different investment returns across funds)

			With profit fund BLAGAB	With profit fund GRB	Non-profit GRB	Total	
Liabilities			100,000	100,000	100,000	300,000	
Free assets				15,000	-	15,000	
Total assets				215,000	100,000	315,000	
Investment Return				7.0%	5.0%		
Income on assets matching liabilities				14,000	5,000	19,000	
Income on free assets				1,050	-	1,050	
Total income				15,050	5,000	20,050	
Free assets			7,500	7,500		15,000	
Proportions for allocating income (S432A)		Life	34.1%			100%	
		Pensions		34.1%	31.7%		
Proportions for allocating income (S432C)		Life					
		Pensions			100.0%		
Income allocated	S432A	**Life**	**6,842**	-	-	**6,842**	
		Pensions	-	6,842	6,365		
Income allocated	S432C	Life	-	-	-	-	
		Pensions	-	-	**5,000**	**5,000**	
Income allocated	S432E	Life	-	-	-	-	
		Pensions	-	**7,525**	-	**7,525**	
Income used in tax	Life S432A		6,842			6,842 }	
	Pensions S432C/E			7,525	5,000	12,525 }	**19,367**
Income left out of account						**683**	

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Apportionment: implications

- **Drives inappropriate behaviour**
  - Companies will test if there are adverse tax impacts from some activities such as writing annuities in a with-profits company
  - Companies will consider holding business in subsidiaries to avoid tax implications
- **Drives inappropriate tax of policyholder benefits**
  - New business is priced assuming matching assets will be taxed consistently with the tax category of the product – rarely the case – why not? Is this fair?

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Apportionment: Alternative approach?

- **Use the allocation of income that is consistent with matching assets for policies (i.e. asset shares) which addresses:**
  - Taxation of income that is expected in policy design
  - Taxes 100% of the income and gains – every time
  - Simplicity – the details are calculated anyway
  - It is consistent with the allocation of expenses
  - Likely to be robust due to regulatory pressures
  - Realistic and consistent with Solvency II?

Matthew Taylor to update on consultation later

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Review of recent HMRC changes: Is it equitable to charge CGT to policyholders?

The Comparison

Investment through a life Company

(With Profit Life bonds, Linked Life bonds)

versus

Direct investment through investment funds

(Unit Trusts, OEICs, etc.)

What's changed?

April 2008 changes

- Personal CGT regime simplification
  - £9,600 annual exempt amount
  - No taper relief (used to be applied to taxable amount pre annual exempt allowance)
  - 18% on gains over that amount for basic and higher rate taxpayers

Example (high rate taxpayer)

- Invest in a company X plc:
  - Investor A invests through a life insurance product
  - Investor B invests through a unit trust
  - Investor C invests in shares directly
- At the end of the year, shares are sold at a £100 gain, how will that be taxed?
  - Investor A taxed £20 in fund then further £16 (20% of £80)
  - Investors B & C previously taxed £40. Could be £24 after 10 years (taper relief).
- Under new rules investor A remains the same but B&C will now pay tax of £18.

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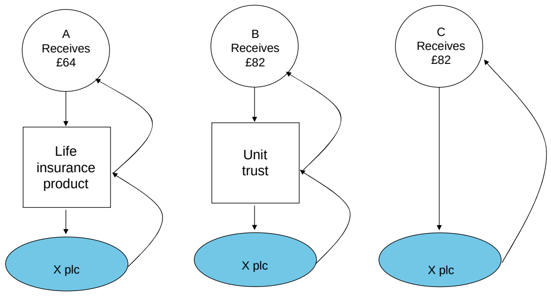
Example: (high rate taxpayer). On the face of it, it looks like bad news…………



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Is the life bond really that bad?

- We should allow for indexation relief on equity/property gains in a life company to make the comparison more realistic
- Deferral of tax on gains until they are realised
- Relief obtainable on non-investment expenses
- Taxation of income is unaffected
- Taxpayers who are expected to become basic rate before maturity

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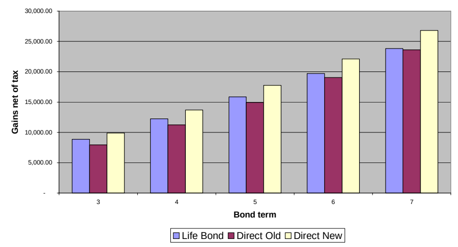
Impact for higher rate taxpayer



The investment results above assume a £50,000 equity style investment earning a 5.0% real return (plus 2.5% RPI) projected over a 3-7 year period, a 20/80 income/capital split, no relief from the use of the CGT annual allowance (£9,600 in 2008/09) and that the investor is a higher rate tax payer.

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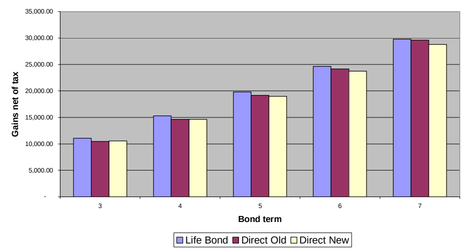
Impact for basic rate taxpayer



The investment results above assume a £50,000 equity style investment earning a 5.0% real return (plus 2.5% RPI) projected over a 3-7 year period, a 20/80 income/capital split, no relief from the use of the CGT annual allowance (£9,600 in 2008/09) and that the investor is a higher rate tax payer.

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Revised thoughts?

- Level playing field before the change
- And now?
  - Life bonds look marginally better for the basic rate tax payer as a result of the CGT change from 20% with taper to 18%.
  - Life bonds look worse off for the higher rate taxpayer as a result of the change from 40% plus taper relief reducing to 18%.
- However the annual exempt amount can have a significant benefit if used. .....but then again it has always been available.

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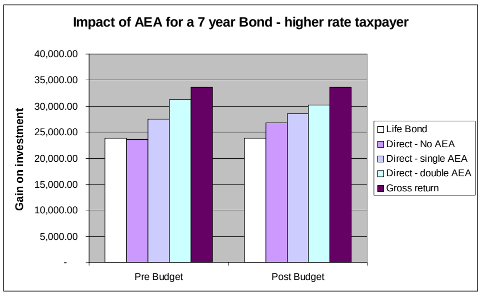
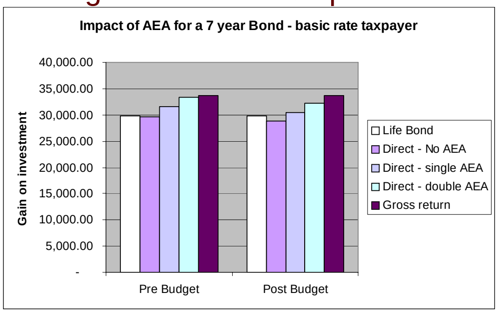
Impact for higher rate taxpayer – allowing for annual exempt allowance



Impact for basic rate taxpayer – allowing for annual exempt allowance



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ABI's proposals

- ABI put forward two proposals to HMT
  - no tax on capital gains in fund, however there would still be tax on chargeable gain on exit. So tax on gains is 16% rather than 36%.
  - no tax on chargeable gains event which would have greatest benefit to policyholder (in the fund they avoid paying tax on indexed gains).

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Why no change by HMT for life bonds?

Sarah Knight, the ABI's assistant director of taxation indicated the following:

HMT argues that: 18% CGT has little impact on the relative returns of direct investment and life bonds as:

- Tax impact depends on asset mix and personal circumstances
- Industry stats show that most life bonds are sold to basic rate taxpayers (80%-90%)
- HMRC analysis of chargeable events regime shows most policyholders are basic rate taxpayers on surrender (95%)
- Bonds benefit from indexation of gains that reduce effective rate to lower than 20% or 40%

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Is this the end for life bonds?

Higher rate taxpayers can minimise tax charge if they:

- Are basic rate taxpayers on surrender; or
- Assign the policy to another basic rate taxpayer. Such a change in tax status is common in helping to relieve the tax burden of the higher rate tax payer.
- Suitable tax planning (via one-off increase in pension contributions but may be retired already)

There are other specific benefits of investing in a life bond, including:

- They can be written in trust;
- They are useful for inheritance tax planning, with a benefit provided on death;
- The tax efficiency can be enhanced by taking up to 5% draw-downs each year (age allowance benefit as this is received as capital rather than income);
- Switching unit funds is possible without surrendering; other assets classes would necessitate realising gains to switch investments; and
- They can be used as part of a wrapper design.

These additional benefits are now even more important to the future success of the life bond.

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Review of recent HMRC changes: Taxing overseas equity dividends as UK equity dividends

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(With Profit Life bonds, Linked Life bonds)

Versus

Direct Investment

and

Investment via Investment Funds

(Unit Trusts, OEICs, etc.)

What's changed?

The changes

- ECJ view that dividends from other Member States must be taxed in the same way as domestic dividends
- Covers both portfolio dividends and group dividends
- Direct personal portfolio dividends already harmonised
- Exemption and withholding taxes

What's changed?

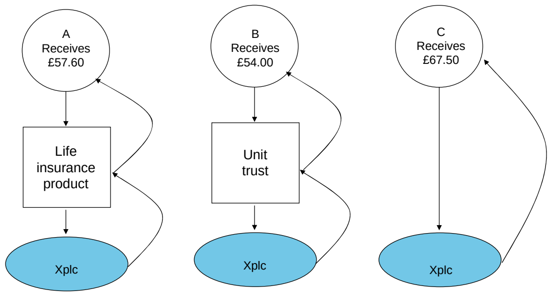
April 2008 changes

- Foreign dividends now receive a tax credit as does a UK dividend
  - This applies to individuals
  - This does not apply to companies (i.e. Life Companies)
  - Certain restrictions
    - Applicable if less than 10% shareholding (but no shareholding restriction from 2009)
    - Tax credit not available if source country does not levy a tax similar in nature to Corporation Tax
    - Anti-avoidance measures, to avoid abuse

Example (high rate taxpayer)

- Invest in a company X plc through:
  - Investor A invests through a life insurance product
  - Investor B invests through a unit trust (e.g. UK CIS with foreign share holdings)
  - Investor C invests in shares directly
- How will a £90 dividend be taxed?
  - Investor A taxed £18 in fund then further £14.40 (20% of £72)
  - Investor B taxed £36
  - Investor C taxed £22.50 plus the tax credit of £10

Example: (high rate taxpayer). On the face of it, could it be more bad news…………?



This is a simplified example

- We have ignored the expenses of management
- A UK based CIS with foreign shares produces a similar tax result to that of a foreign CIS with foreign shares

Revised thoughts?

- This is the current position
- Thoughts?
  - Direct investment has a competitive advantage over both life bonds and CIS.
  - Life bonds have a competitive advantage over CIS.
  - Life bonds can roll up the foreign dividend income over the term of the bond. This can be of benefit to the policyholder if on exit they suffer BRT.

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Financing-arrangement-funded transfers

- Why do we need rules to deal with financing arrangements
  - Case I profits derived from an insurer's surplus – including investment reserve for non-profit companies
  - Most financing works by increasing this aggregate surplus
  - So unless there are special rules, financing will incur a tax cost
- But HMRC want to preserve a Case I profit where financing funds a transfer to shareholders
- Pre-2008 rules (s83ZA) were complex and restrictive and so consultation last year focused on a new set of rules that have been enacted and can be used for financial reinsurance as well as contingent loans.
- Effects on Case I profits
  - Receipt of loan/reduction in liabilities is ignored for Case I purpose
  - Making a shareholder transfer out of financing surplus gives a Case I receipt
  - Repayment of a loan/recapture of liabilities is also ignored for Case I purposes
  - …unless there's been a transfer out of financing surplus in the meantime where the tax effects need reversing

Overall, the rules should only have a timing effect on profits

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Other recent consultation and budget changes

- May 2006 consultation
  - Transfers of business (complete)
  - Amalgamation of tax categories (complete)
  - Crown option (complete)
  - Apportionment of income and gains (outstanding)
- Reinsurance changes
- Transfers into the long-term fund
- Other corporation tax issues (including PBR 2008 if it has occurred)

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Transfers of business

- HMRC perceive new forms of abuse every year
- HMRC responded to each new abuse with new anti avoidance legislation
- HMRC now have a principle based approach
- Aim to ensure that profits that would be taxed absent a transfer will also be taxed despite a transfer

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Amalgamation of tax categories

Previously	Now
Pension Overseas life assurance Life reinsurance Child trust funds ISA	Gross roll-up

Transitional arrangements apply for the relief of existing losses in the new tax category

BLAGAB and PHI remain unaffected

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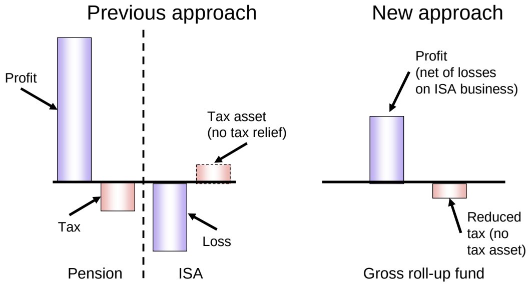
Effect of amalgamation of tax categories



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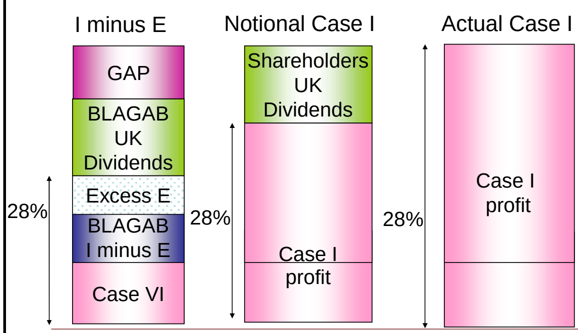
Comparison of bases of taxation



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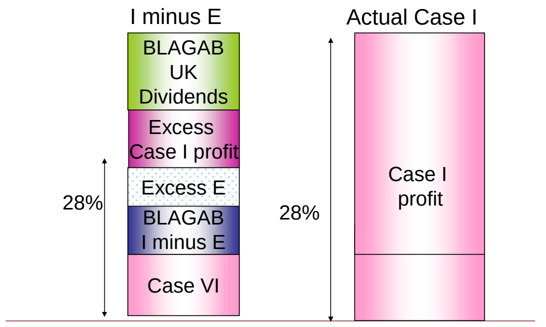
Crown option – the solution



Apportionment: what were the options?

Approach 1: Apply s432A across whole company for all purposes
Doesn't reflect Needs/Floor position for WP GRB

Approach 2: Apply s432A on a fund by fund basis
Still doesn't reflect Needs/Floor position for WP GRB

Approach 3: Apply s432C for NP for all purposes
Apply s432E for WP for all purposes
Is s432E appropriate for BLAGAB I minus E?

Approach 4: Scale up or down to reach 100%
Neither BLAGAB not GRB has "reasonable" allocation

Possible compromise position of option 3.5

Option 3.5

- No longer requires 100%
- Allocate each sub-fund separately
- Use s432C for NPF (BLAGAB & GRB)
- Use s432C for BLAGAB and s432E for GRB for WPF

Potential issues

- Still potentially results in taxable income exceeding 100%
- Identify income, mark to market movement at fund level?
- Capital boxes must be maintained at fund level?

Reinsurance changes

- Fronting reinsurance:
  - Denial of relief for commissions where a life company reinsures business to company connected with source of business and does not receive reinsurance commission in return
- Deposit back interest:
  - Direct attribution to relevant category of business replaces apportionment

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Foreign profits

- Dividends part of wider package introduced by discussion document in June 2007
- Areas of study:
  - Dividend exemption
  - Interest cap
  - Controlled foreign companies
  - Treasury consent
- Ministerial decisions awaited so detail not public

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Other prospective changes

- Transfers into the long-term fund:
  - HMRC want to tax transfers into the long-term fund where:
    - The amount is then added to the excess value of assets" in Form 14 line 51,
    - there is an "excess value of assets" which could be used instead, or
    - they think there is an acceleration of surplus
- Structural assets:
  - HMRC want to extend rules to cover loans to group companies ending the use of the counterparty limited loans to manage taxable surplus
- Pre-Budget Report 2008?

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Agenda

- Reprise of life office taxation
- Why do HMRC not respect the matching of assets and liabilities?
- Is it equitable to charge CGT to policyholders? Review of recent HMRC changes
- Taxing overseas equity dividends similarly to UK equity dividends
- Taxing all forms of financing (both reassurance and non reassurance)
- Review of other recent consultation and budget announcements
- Appendix: Glossary

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Glossary of terms

- AEA – annual exempt allowance
- BLAGAB – basic life assurance and general annuity business
- Case VI – the technical name of the tax computation for GRB profits
- CGT – capital gains tax
- FA – free assets
- GRB – gross roll-up business
- ISA – individual savings account
- NCI – Notional Case I
- PBR – pre-Budget report
- PHI – permanent health insurance

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