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Life office tax overview

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Introduction

- Why worry about tax?
- A simplistic tax model
- How important is it to manage the I - E position?
- What tax formula should I use in my profit-testing model?
- Some complications
- Some practical investigations

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Why worry about tax?

- Tax returns for HMRC (Her Majesty's Revenue & Customs)
- Product design
- Profit reporting (Pillar 1, 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

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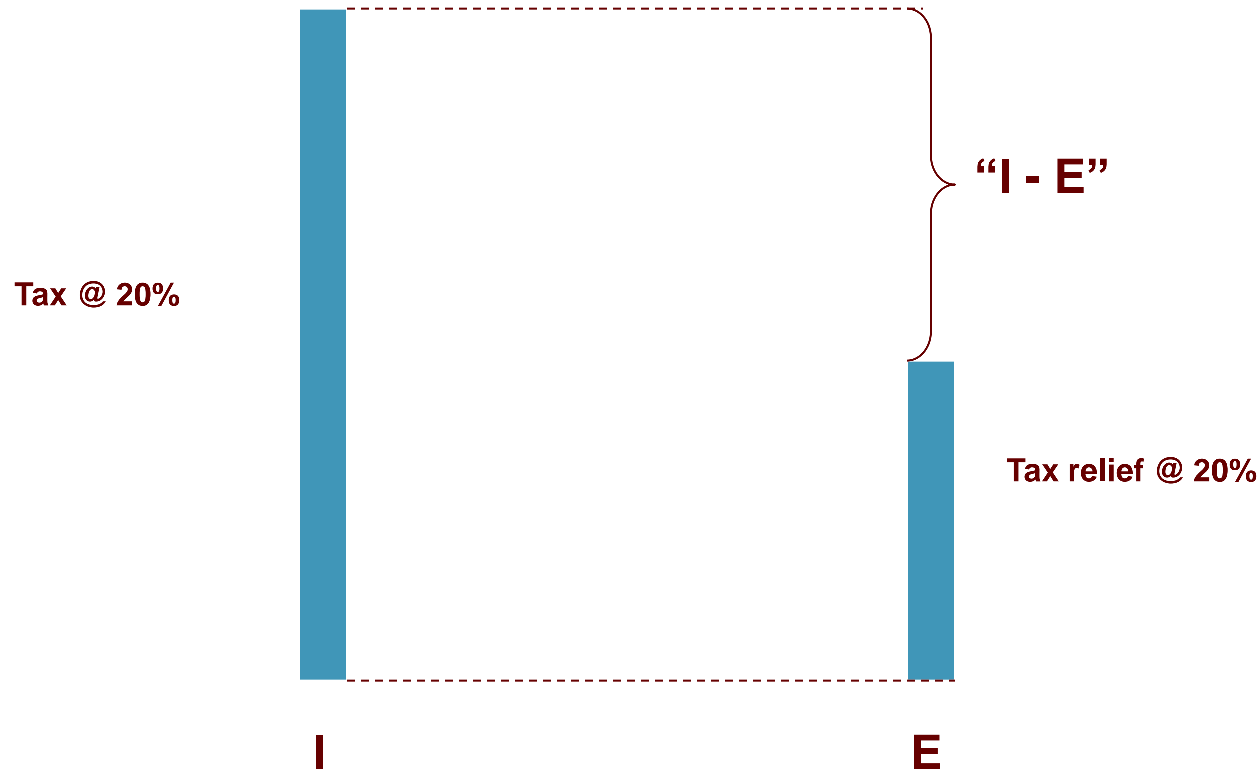
Simplistic tax model: Mutual life insurer



Pre-tax profit earned by Life Office =	+ Premiums	+ Investment Returns	- Expenses	- Claims	(+ timing)
Pre-tax profit earned policyholders =	- Premiums			+ Claims	(- timing)
Aggregate pre-tax profit to tax =		+ Investment Returns	- Expenses		

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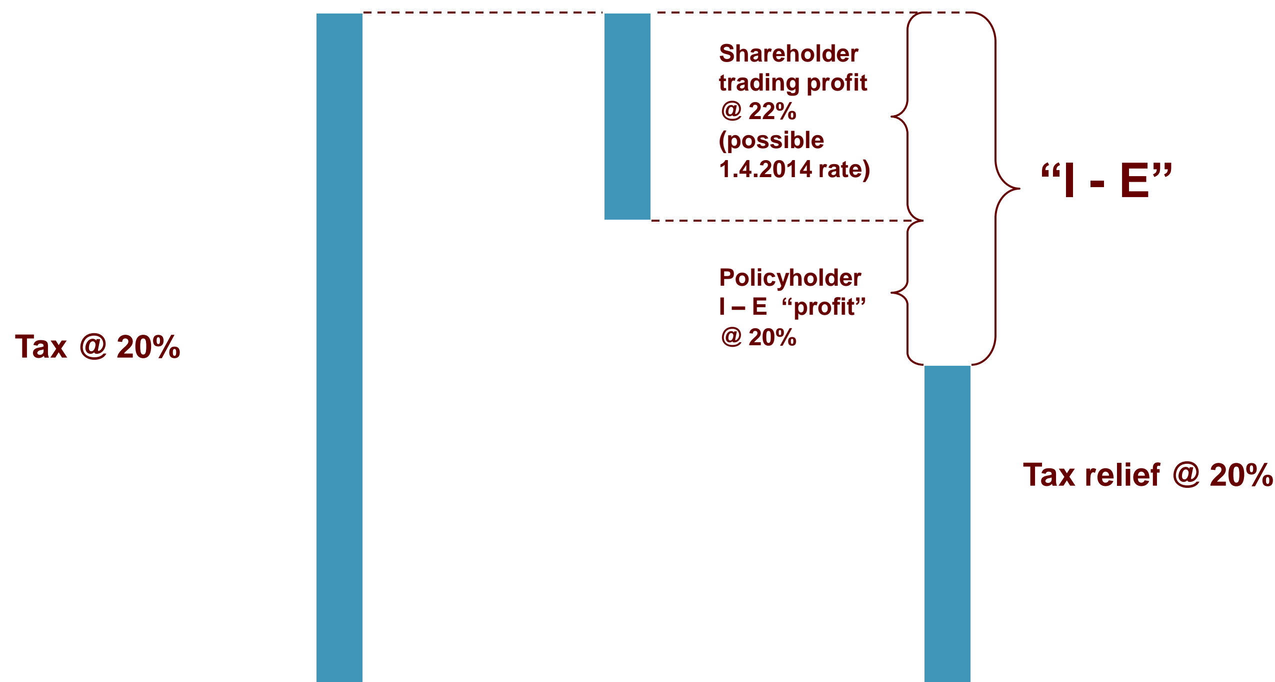
Simplistic tax model: Proprietary life insurer Net (or Excess I) situation



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

Shareholder trading profit @ 22% (possible 1.4.2014 rate)

"I - E"

Tax @ 20%

XSE (XSACI) i.e. c/f relief @ ?%

Immediate relief @ 20%

I NCI E

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How important is it to manage the I - E position?

- I – E management used to be very important
  - When XSE could generate tax relief of (28% - 20%) or higher
  - When I from GRU business leaked into, and profits from GRU business affected, the I – E computation
  - When BLAGAB new business was a mix of XSE and XSI
- None of this is the case anymore (from 1.1.2013)
  - XSE tax relief will (probably) be (22% - 20%) by 1.4.2014
  - GRU business has no effect on I - E
  - New protection business is all classed as GRU
- XSE may now just be a relatively minor form of taxable loss

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What tax formula should I use in my profit-testing model?

- Most reserving / profit-testing models (Prophet, Moses, …) make a reasonable but simplistic tax assumption
  - E.g. 22% pillar 1 profits for Pensions business written in a proprietary company
- But …
  - Overall company tax bill is not the same as the sum of the tax bills from each of the company's lines of business (e.g. usage of losses, some lines XSI, some XSE)
  - And tax bills from 1.1.2013 are based on trading profits (UK accounts), not pillar 1 profits

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Complications: I

- Most investment returns 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)
- E.g. unit price = (MV – 20% x IUCG x v^{-t}) / Number of units
  - Can either view the adjustment as removing present value of future tax, or recognising that the fund has a small degree of gearing through holding its CGT reserve, with this gearing being likely to generate additional value

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Complications: losses in UL / WP funds

- Many unit-linked or with-profits funds are charged tax as if they were a stand-alone mutual company
- Where such a fund generates losses, it only receives tax relief for those losses if / when the fund subsequently generates sufficient investment returns to frank those losses, so
  - The unit price for a fund with unused prior period losses may be precisely the same as the unit price for an identical fund with no losses – but the former fund has the potential to grow tax-free
  - If the company franks the losses earlier, should the fund share in the benefits? (Beware: adjusting unit prices upwards before the losses are franked can create pillar 1 valuation strain).
  - If the fund expires in a taxable loss situation, who benefits from the taxable losses?

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Complications: Taxable losses & E

- Not always allowed to count taxable losses for valuation purposes
- Valuation should be cautious if usage isn't certain:
  - For traditional EV, possibly write down asset value to allow for probability asset won't be used as quickly / at all
  - After a 1-in-200 1-year ICA stress test, it may take a long time / forever to use all the losses
- Apportionment of E by line of business is on a commercial basis

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A practical investigation

	Tax bill, £m
Simple expected tax bill (19.5% x (I – E) + 2.5% x BLAGAB trading profits + 22% x GRU trading profits)	(20)
Apportionment rules for I mean some I from GRU business leaks into I – E calculation (this shouldn't happen post 1.1.2013)	(15)
Poor new business volumes this year (deferred E reduces)	20
Poor new business volumes this year (XSE reduces)	10
New business strain creates trading profits losses (unrelieved this year)	(1)
Some GRU losses from prior years used in this year's tax computation	5
Tax bill calculated by business plan tax model	(1)

When office is Excess I: tax = 20% x (I - E) + (22% - 20%) / (1 - 20%) x max (0, pre-tax profit - 20% (I - E))

A little bit of rearrangement gives tax = (20% - (2% / 80%) x 20%) x (I – E) + (2% / 80%) x pre-tax profit

… or tax = 19.5% x (I – E) + 2.5% x pre-tax profit

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