Ernst & Young

# Taxation of long-term business (November 2010)

## Introduction

This paper seeks to provide a high level description of the taxation of long-term business in the United Kingdom.

## Long-term business

### *Categories of business*

Long-term business is defined as contracts within part II of schedule 1 to the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 (SI 2001/544). For tax purposes it is divided into several categories as follows:

- life assurance business, which is itself split into:
  - basic life assurance and general annuity business (“BLAGAB”);
  - pension business (“PB”);
  - overseas life assurance business (“OLAB”);
  - life reinsurance business (“LRB”);
  - individual savings account business (“ISAB”); and
  - child trust fund business (“CTB”); and
- other long-term business, principally permanent health insurance (“PHI“), capital redemption business (“CRB”) and pension fund management (“Class VII”).

It is important to note that, in a tax context, the expression “gross roll-up business” (“GRB”) is used collectively for PB, OLAB, LRB, ISAB and CTB and that “life assurance business” includes GRB as well as BLAGAB. The term “PHI” is also now used in tax legislation to denote long-term business other than life assurance business.

### *Bases of taxation*

*Trading profits*

The conduct of insurance business is a trade, but for tax purposes a company writing life assurance business is treated as having a separate trade from other insurance business including other long-term business.

If all, or substantially all, of the life assurance business of a company is GRB, the company is taxed on its trading profits. Otherwise, it is taxed on its investment income and chargeable gains less expenses (the “I minus E” basis) more or less as if it were the business of an investment company

An important feature of the life assurance tax regime is that the basis of determining the trading profit is the surplus in the regulatory returns rather than the profits in the Companies Act accounts. This reflects the legal restriction on the distributability of profits by reference to actuarial surplus.

PHI and Class VII business should however be taxed separately on the basis of the Companies Act accounting profits although Class VII business is often aggregated with PB and treated as life assurance business for tax.

*Life assurance trade profit*

Where the I minus E basis is used, special provisions ensure that the profits on the I minus E basis are at least as great as the taxable profits on a trading basis. The mechanism for achieving this is commonly known as the "excess trade profits" calculation, because it involves calculating the life assurance trade profit and adding an additional amount to the I minus E computation so as to achieve equality of profits.

For the purpose of this calculation, BLAGAB exempt dividends are included as the top slice of the I minus E figure. Exempt BLAGAB dividend income is also treated as forming part of the life assurance trade profit. Normally, this exempt dividend income is derived by multiplying the BLAGAB exempt dividend income by the ratio of the life assurance trade profit to the investment return less expenses and interest taken from the revenue account in the regulatory returns. If, however, this ratio would give a result greater than one or less than zero and there is a life assurance trade profit, the ratio is treated as being one and the whole of the BLAGAB exempt dividend income is treated as the top slice of the life assurance trade profit.

The life assurance trade profit is determined after deducting the cost of bonuses and any tax on I minus E profits in excess of the life assurance trade profit itself. The life assurance trade profit test is only applied in the computations of a proprietary company and not in those of a mutual.

*Policyholder taxation*

The principal effect of the use of the I minus E basis is to tax the investment income and gains arising from the investment of policyholder's premiums thus ensuring that the fund out of which claims will be paid has borne taxation. This in turn means that many policyholders do not need to be taxed when the policy proceeds are received. The policyholder tax regime reflects this and only imposes tax at the higher rate. Certain regular premium policies lasting more than ten years are exempted from this higher rate tax.

The taxation of investment income and gains is not applied to categories of life assurance business other than BLAGAB: in the case of PB, ISAB and CTB as a matter of public policy, in the case of OLAB because the policyholders are not resident for tax in the UK and in the case of LRB because tax on investment income and gains is applied in the cedant not the reinsurer. GRB is therefore taxed only by reference to surplus available for shareholders. Strictly this would be a trading profit, but if the I minus E basis is applied, it cannot technically be trade profit and is treated as miscellaneous income. In contrast, CRB, which is not strictly life assurance business, is taxed as if it were BLAGAB. BLAGAB expenses may only be relieved against the investment income and gains of the BLAGAB business and not against GRB profits.

*Summary*

Three broad bases of taxation are thus generally applied to long-term business:

- taxation on trading profits as shown in the financial; statements for PHI and some Class VII;
- taxation on surplus as shown in the regulatory returns for GRB; and
- taxation on income and chargeable gains less expenses of management for BLAGAB and CRB.

***Rates of tax***

Two rates of tax are currently applied in the tax computations of companies writing long-term business:

- the full rate of corporation tax (28% for 2010/2011 and 27% for 2011/2012) is applied to PHI and Class VII profits and to the I minus E profit up to a maximum of the life assurance trade profit less any part of the BLAGAB exempt dividends treated as forming part of it; and
- the basic rate of income tax (20% for 2010/2011 and 2010/2011) is used as the rate of policyholder tax which is applied to the remainder of any I minus E profit.

**Allocation of profits between categories**

***Items other than investment return***

Items other than investment return and interest payable on reinsurance deposits are allocated between the various categories of long-term business on an actual basis. Premiums, claims and the movement in the liability to policyholders are split between categories in the regulatory returns and these splits should be used as far as possible. Other items must be split, if possible, by reference to the company's accounting records, but, in some cases, such as allocating the cost of support departments, an apportionment may be necessary by reference to some suitable alternative measure. For example, the cost of maintaining the computer system may be apportioned by reference to the numbers of policies in each category. For PHI and Class VII, the allocation must be of items in the modified statutory accounts. For life assurance business the allocation must be of items in the regulatory returns.

***Investment return and loan interest payable***

The allocation of investment return is more complex and reflects the different bases of taxation for the various categories of long-term business. There are two basic approaches: one is used for BLAGAB and CRB I minus E and for the trading profits of PHI and Class VII, the other for GRB and life assurance trade profits. The first method is used for loan interest payable, except for interest on reinsurance deposits and late paid claims which are attributed directly to the relevant category of business.

*Mean fund apportionment for I minus E*

Mean fund apportionment is the term used to describe the apportionment for I minus E, PHI and Class VII. It seeks to apportion investment income, chargeable gains, accounting gains and interest payable by reference to an allocation of the long-term business assets. Chargeable gains will be included in BLAGAB and CRB I minus E. Accounting gains will be included in the PHI and Class VII trading profits. Loan interest payable will be included in

BLAGAB and CRB I minus E, in PHI and Class VII trading profits and in the GRB Case VI computation.

The allocation here is made by reference not to the assets themselves but by reference to the liabilities of the long-term business. The allocation to each category is then expressed as a percentage of the total and the percentage used to apportion the income and gains.

The allocation has three steps:

- the first step is the calculation for each category of the mean liabilities to policyholders ("mathematical reserves") including declared reversionary bonuses from the regulatory returns;
- the second is the deduction of the mean amount of property linked net assets; and
- the third is to add amounts for the mean free assets which are defined as being equal to the long-term liabilities disclosed in the regulatory returns plus money debts less the mathematical reserves and declared bonuses; the free assets would thus include both liabilities which have fallen due and the value of additional amounts not yet appropriated to policyholders.

The first and third of these steps produce an allocation of mean total assets. The second ensures that the percentages only reflect the split of assets not linked to particular categories.

There are two supporting allocations to consider:

- net assets which are property linked to more than one category are split by reference to the mean property linked mathematical reserves of those categories; and
- the free assets are split by reference to mean with-profit mathematical reserves plus reversionary bonuses, unless these are less than five per cent of the total, otherwise it is split by reference to mean total mathematical reserves.

Once the apportionment fractions have been determined:

- income and gains from property linked assets linked to one category or those attributed to OLAB as foreign business assets are allocated to those categories;
- income and gains from property linked assets linked to more than one category are apportioned to those categories by reference to property linked mathematical reserves;
- the remaining income and gains are apportioned by reference to the mean fund apportionment fractions;
- loan interest payable on loans attributed to property linked funds is allocated to the categories to which those funds are linked;
- other loan interest payable, except that on reinsurance deposits and late paid claims which are attributed directly to the relevant category of business, is apportioned by reference to the mean fund apportionment fractions.

*Apportionment for life assurance trade and GRB profits*

Apportionment is also needed for the life assurance trade and GRB profits. The subject of the apportionment is the investment return from the regulatory returns whether investment income or the movement in investment values brought into account. There are two methods used: one for with-profits business and one for non-profits business. Where parts of the long-term fund are dealt with as separate funds, including separate forms 40 and 58, in the regulatory returns, the methods are applied to each part separately.

The method for a fund or part of a fund containing with-profits business is principally designed to secure that the profit before technical tax adjustments for each category is that proportion of the surplus for the period after deducting bonuses which the bonuses allocated to the category bear to the total bonuses. The investment return is that needed to achieve this result and the method is known as the “Needs” basis. If the “Needs” basis investment return proves to be consistently lower than an alternative measure based on the rate of investment return actually recorded in the regulatory return, it will be replaced by it. This alternative, which is very rarely required, is known as the “Floor”.

The method for a fund or part of a fund containing no with-profits business is similar to mean fund apportionment except that only mean mathematical reserves less property linked net assets are used in the calculations. One effect of this is that the mean fund apportionment used to apportion investment income and gains for I minus E may differ significantly from that used for investment return for GRB. In some cases more than 100% of the income may fall into the various computations and in other cases less.

*Consequences*

The taxation of a particular investment made by a long-term fund will depend on:

- whether it is directly property linked to a category of business;
- if not, the categories between which the investment return from it will be apportioned;
- the treatment of investment income and gains from it for BLAGAB and CRB I minus E and PHI and Class VII profits; and
- the treatment of investment return from it in the regulatory returns for life assurance trade and GRB.

**Technical adjustments**

***General***

Where adjustments would be required in the tax computations of companies generally, those adjustments are made to the computations of companies writing long-term business. The adjustments must however be allocated amongst the categories of long-term business for inclusion in the computation in the same way as the accounting items to which they are adjustments for tax.

***Income***

Income for I minus E is generally that arising from the assets of the long-term business, but there are three areas worthy of specific note:

- the taxation of income from, and capital movements in, loan relationships is generally determined by the accounting treatment in the modified statutory or IFRS accounts used for filing with the Registrar of Companies;

- certain specific areas of investment activity such as foreign exchange, financial instruments (principally interest rate derivatives) and loan relationships are subject to tax on an accounts basis; the tax regimes normally applied here are modified for life assurance business and apply only to amounts apportioned to BLAGAB; they are disapplied for GRB which is taxed only by reference to what is brought into account in the regulatory returns;

- certain profits from investments are generally taxable as trading profits but not as investment income or chargeable gains; examples include stock underwriting and unit trust management fee rebates; these are treated as miscellaneous income for I minus E and the amount apportioned to BLAGAB is taxed there; and

- income and gains on "structural assets" in a non-profit fund, currently shares in and loans to insurance dependents, are treated as not arising from the long-term business and are taxed separately with income and gains from other than long-term business assets.

***Gains***

Special provisions apply to investment in collective investment schemes. Where gains from such investments would be apportioned to BLAGAB, the investments are deemed to be sold and reacquired at the end of each accounting period. The resulting gain is then spread over seven years for inclusion in the I minus E computation.

***Expenses***

Certain items are not allowed as expenses in the BLAGAB I minus E computation but are deductible in the life assurance trade andr GRB computations. These include:

- premiums whether refunds or reinsurance;

- profits commissions or participations;

- commissions paid where the business is reinsured without commission to a captive of the distributor;

- amounts paid to policyholders or their representatives; and

- where the purpose of the expense is not a business or other commercial purpose of the company.

Special provisions apply to expenses of acquiring business and to commissions in particular. Where such expenses are allocated to BLAGAB, relief for the expenses must be deferred and spread over seven years for inclusion in the I minus E computation.

Only accounting reversals, for example of provisions, are treated as negative expenses. Actual receipts, for example of reinsurance commission are treated as miscellaneous income for I minus E and the amount referable to BLAGAB is taxed there.