Taxation of disability business

Actuarial Profession Life Office Taxation Working Party

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This note considers the taxation of non-profit disability business in a proprietary company. Whilst the business is basically taxed on a gross basis, there are a number of surprising issues which arise.

It is most unusual for this business to be written on a with-profit basis, hence this is not considered here.

Principles

Disability business, largely permanent health and critical illness, is taxed on a Case I profits basis at the corporation tax rate (currently 30%) using Companies Act Report and Accounts figures (UKGAAP). Three major issues are:

a) profit includes movements in deferred acquisition costs (DAC);
b) unrealised gains have historically been excluded;
c) tax computations are based on the reserves in the Accounts which are likely to differ from the FSA reserves used for mean fund and modified mean fund apportionment.

Gains on equities are calculated on a 'book' basis with no indexation, and have historically been taxed only upon realisation by sale or transfer of the relevant assets. The Inland Revenue however issued a Press Release on 1 August 2001 about changes to this treatment which has been followed by draft legislation. Broadly, the Inland Revenue have concluded that, for all periods from 1998 onwards, companies which adopted the mark-to-market basis of accounting for equities under the Statement of Recommended Practice on Accounting for Insurance Business should also be subject to tax on the whole of the gains brought into the profit and loss account in the period whether realised or not.

Although the Inland Revenue are taking a cavalier approach to this issue and their position is far from general acceptance, they have said that they will not seek to overturn the realisation basis and tax unrealised gains for periods up to the one covering 1 August 2001 or, if the company so elects, arising subsequently on assets held on 1 August 2001.

Bond gains are taxed under loan relationship rules, again with no indexation, even for index-linked bonds. Historically the valuation of bonds in UKGAAP could be on either a market value basis or an amortised cost (accruals) basis. If the former, there was an election in the tax computation to substitute an accruals basis for any or all bonds. This election was intended to be temporary and has not been extended beyond 31 March 2000.

There is significant flexibility to offset losses against other profits in a corporate group. Losses can be group relieved or carried forward against future disability profits or offset against profits of any description in the current year or the previous year.

In computing profit, mismatching reserves, contingency reserves, etc are disallowed and FII is excluded from taxable income.

Practical issues

1. The presence of DAC defers tax relief on initial expenses so consideration needs to be given to this in pricing.

2. Where one has a unit linked disability contract, it is likely that the fund link will be shared by a BLAGAB contract, so that the fund will be treated as 'mixed linked' and not 'sole-linked'. Thus income and gains are mean fund apportioned, giving rise to potential tax distortions not likely to be reflected in unit pricing. In principle these are the same distortions as also occur in mixed-linked BLAGAB/pensions unit funds.

3. There are further issues around situations where policies have benefits which are partly in the BLAGAB fund and partly in the disability fund, for example a Flexi Whole Life product with a disability component. How does one split revenue between the funds? On the one extreme the disability fund might only receive the disability risk premium component of the product, or it might receive a fully loaded share of the premium. Similarly how do you charge the related expenses to the different funds? There may be tax advantages in establishing one method rather than another because of expense relief or because of the incidence of profits tax.

4. Some products have disability benefits as riders e.g. waiver of premium, PTD. It is possible, but not essential, to include these benefits in the fund to which the major part of the policy's benefits belongs. Again there could be tax advantages or disadvantages in taking a particular approach, although one might decide that the system/administration costs outweigh the benefit of splitting the figures.

5. For Notional Case I calculations 'PHI' profit is excluded on an FSA return basis, with investment returns allocated on a mean fund basis. This can lead to considerable distortions if there is a large Tax Investment Reserve because of the allocation of taxable income and gains on a modified mean fund basis, although recent changes in legislation have reduced the distortion.

The above does not constitute a full description of the taxation of disability business, but hopefully does serve to highlight the most important issues which may arise.

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