8 November 2004

Working Party: Life Office Taxation

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Agenda

Finance Act 2004

Contingent loans

Financial reinsurance

Implications of realistic reserving

Latest news

Finance Act 2004

Expenses of management

Other insurance issues:

- Immediate needs annuities
- Hypothecation
- Corresponding deficiency relief

Transfer pricing

Disclosure

Expenses of management

De-coupling

Disallowables

Negative amounts

Steps

Transition

Decoupling

Previous legislation attached relief for expenses of management of basic life assurance and general annuity business ("BLAGAB") to the rules for expenses of management of investment companies

New legislation stands alone

Consequences for application of case law

Taxation of "shareholders' fund" as ancillary investment business

Disallowables

Payments to policyholders – mis-selling compensation

Payments to those acting for policyholders – does not include IFAs

Profit commissions however described

Uncommercial purpose – no need for pre-tax profit

Negative amounts

Simple reversals – eg releases of provisions never utilised – are still negative expenses

Reimbursements – eg reinsurance commission or cost allocations to other companies - are miscellaneous income

Implication of apportionment not allocation

Steps 1 to 5

1 Identify expenses payable

2 Exclude those deductible elsewhere

3 Add those specifically deductible

4 Subtotal 1 = steps 1 – 2 + 3

5 Deduct expenses given up to match Notional Case I loss (= subtotal 2)

Steps 6 to 10

6 Deduct 6/7 of current year acquisition expenses (= subtotal 3)

7 Add expenses brought forward (= subtotal 4)

8 Add 1/7 of prior period acquisition expenses

9 Minimum profits test to determine excess expenses

10 Carry forward deferred expenses

Transition I

Commencement date for expenses - 1 April 2004

Split accounting periods straddling this date

Use rule B even though strictly it doesn't apply

Commencement date for miscellaneous income – start of next accounting period after 31 March 2004

Rules for timing

Rule A	If the period of account is the same as the accounting period, use it
Rule B	If period of account > 12 months, time apportion
Rule C	If period of account < 12 months, use deemed FSA return
Rule D	Specific statutory rules (eg pension scheme payments)

Other insurance issues

Immediate needs annuities:

- Used for long-term care
- No taxation of the policyholder
- Effect on taxation of company

Hypothecation

- where it is necessary…

Corresponding deficiency relief

- only where gains taxed on same person

Transfer pricing

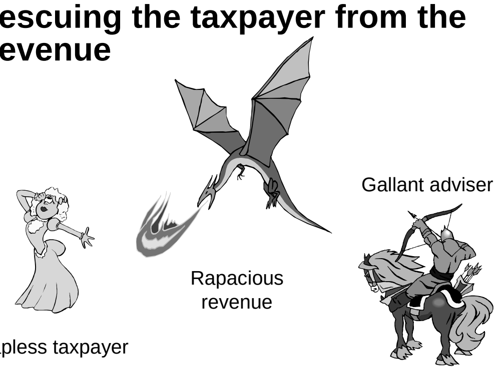
European Court challenge

Regime extended to intra-UK transactions

Already applied to life companies

Not intended to change

Rescuing the taxpayer from the Revenue



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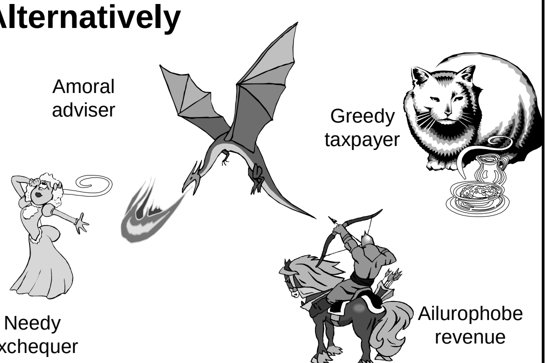


Disclosure

Financial and employment products

Promoters – tax services and banks

Premium fees and confidentiality

“Making available”

5 days or first transaction - lawyers

Computation disclosure for in house planning

Contingent loans – 2003 rules

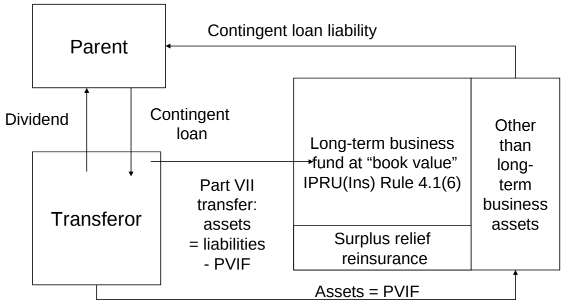
Amounts credited and debited through lines 12 to 15 of form 40 are *prima facie* taxable under section 83(2) FA 1989

Special rules for contingent loans credited through form 40

Assets extracted directly from the long-term business outside form 40 are taxable under section 83(2B) FA 1989

But not repayments of debts where the receipt of the principal was not recognised in line 15 of form 40 as a taxable receipt

Contingent loans – mischief?



How do the tax rules work?

Loan receipts through form 40 are taxable

Relief is available for unrepaid loans but not:

- if there are shareholder transfers*, or
- if there is a deficit on a part VII FSMA transfer in

Relief is available for repayment through line 25 of form 40

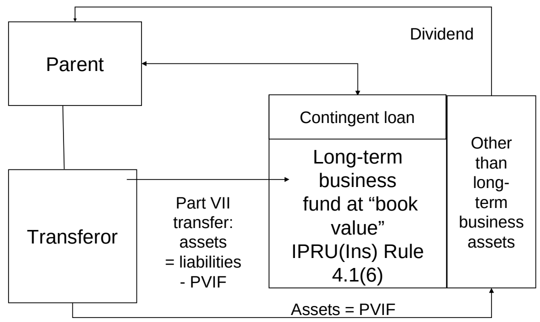
* transfers of up to 12% of bonus from with-profit funds do not count here

Sections 444AA and AE

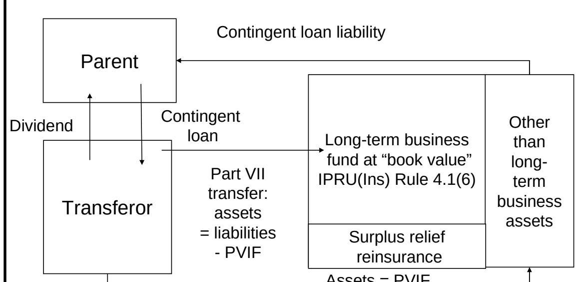
Section 444AA ensures that there are deemed FSA returns for the period ending immediately before the transfer and the period of the transfer if there are none such filed

Section 444AE provides that contingent loans are treated as repaid by the transferor and re-borrowed by the transferee. The deemed repayment is immediately before the transfer so that section 83ZA relief for the repayment will not apply

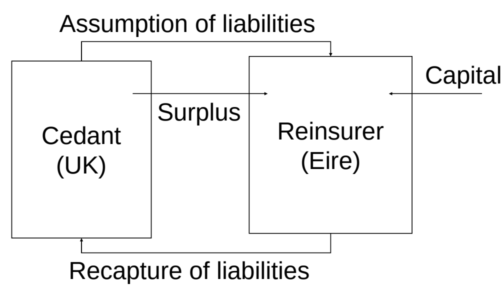
This still works



Financing reinsurance – mischief?



Financing reinsurance - detail



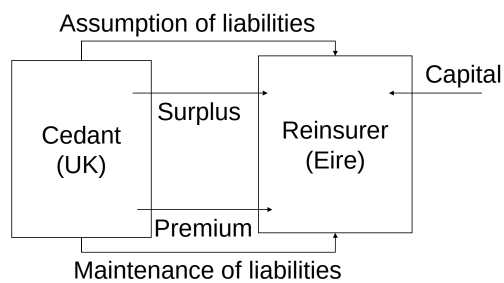
How do the new tax rules work?

Where some or all liabilities can be recaptured without a right of recovery

Where assets were transferred to the cedant under part VII FSMA 2000 which were of lower value than the liabilities and the deficit was made good by the reinsurance

In these circumstances the reductions in the reinsured liability without payment are taxable on the cedant

Financing reinsurance – what can be done



Financing reinsurance - pitfalls

Tax is now deferred not eliminated

Premiums for BLAGAB can give rise to annual deemed investment return if investment risk is reinsured

Capital funding can now also give rise to annual deemed investment return if from a connected party and reinsurance is of BLAGAB investment risk

Realistic reserving

Required minimum margin (Peak I) is still used for tax

Impact is on calculations not computations

Requirement for explicit deferred tax liabilities

No scope for recognition of deferred tax assets

Use of peak I surplus

Inland Revenue SP 4/95

"… the convention of using actuarial surplus as a substitute for commercial profit has been firmly established for many years. … We have received legal advice that … this convention is implicit in the special statutory rules relating to life assurance business and in particular FA 1989 s83."

IPRU(Ins) Rule 4.1(6)

[Subject to the valuation of asset rules] "an insurer may, for the purposes of an actuarial investigation, elect to assign to any of its assets the value given to the asset in question in the books or other records of the insurer."

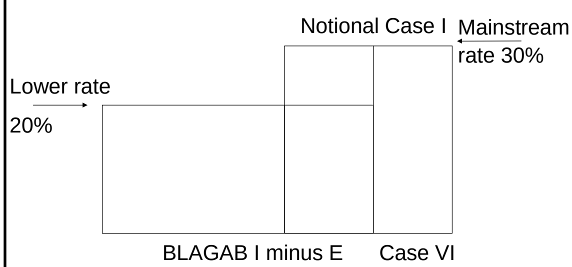
Tax Modelling

- Simple asset models do not require complex tax models
- Complex asset models do
- Market standardisation in other areas is moving towards more complex tax modelling
- Aggregate tax on each scenario differs from tax on aggregate scenario

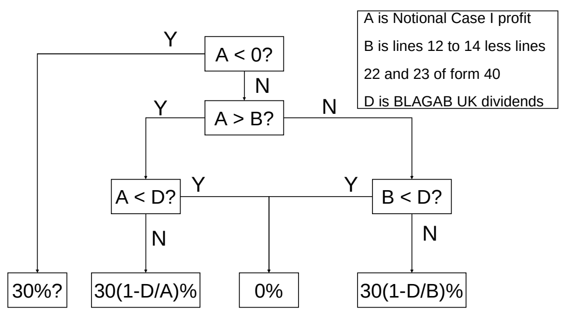
Tax Modelling - Developments

Traditional position	Future position
Policy by policy deterministic embedded value with single effective tax rates	Stochastic projections of gross asset and liability cashflows
Sometimes enhanced by specific aggregation of gross cashflows to derive the effective tax rates	Scenario-dependent tax calculations on aggregated cashflows
No allowance for "real world" variability in tax status	"Corporate Model" talking to the liability model
	Effective tax rate is an output not an input

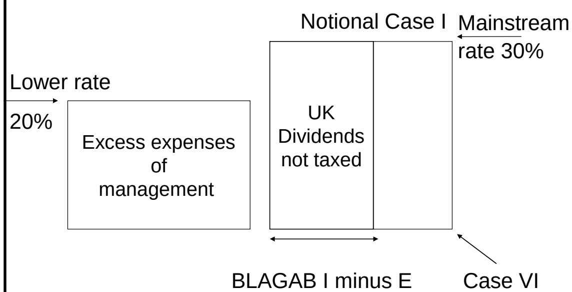
The traditional model



Effective rates – excess I



Extreme scenario?



Latest news

IFRS

FRS 25 and 26

FRED 34

Pre Budget Report

IFRS in the UK

IFRS is permitted to be used in UK financial statements and tax computations from 1 January 2005

IFRS however can mean two different things:

•True IFRS as promulgated by the IASB

•EU GAAP as adopted by the EU

Furthermore, UK GAAP is being converged with IFRS by the issue of new UK standards

Who can use IFRS

Group accounts of EU listed companies	IFRS (EU GAAP) compulsory
Stand-alone company accounts of EU listed companies	IFRS or UK GAAP
Stand-alone accounts of subsidiaries of EU listed companies	IFRS or UK GAAP, but IFRS compulsory if any use IFRS
Other companies	IFRS or UK GAAP
Other entities	UK GAAP

IAS 39 - developments

Balance sheet based approach based on fair values of assets and liabilities at the balance sheet date

Not intended for use by regulators

Not designed to demonstrate liquid taxable capacity

Issue over fair value of liabilities, default is amortised cost

Fair value option restricted under EU GAAP to exclude financial liabilities

Accounting for unit-linked business

Fair value of liability not to exceed fair value of assets

If policyholders would suffer the cost if deferred tax charged were not discounted the fair value of the liability can reflect this

Amortised cost is unit price because of:

- Embedded derivative for cancellation
- Daily repricing sets effective yield; or
- Floating rate contract

FRS 25 and 26

Import IAS 32 and 39 into UK GAAP from 1 January 2005

This is true IFRS not EU GAAP

Only applies to some companies with FRS 25 disclosures applying to more than FRS 26 accounting requirements

Who must use FRS 25 and 26

Group accounts of EU listed companies	IFRS (EU GAAP) compulsory
Stand-alone company accounts of EU listed companies	FRS 25 and 26 compulsory including where listing is of debt only and if using UK GAAP
Other companies	FRS 25 compulsory, FRS 26 optional if using UK GAAP

Inland Revenue response - principles

Broadly equivalent tax treatment to current UK GAAP:

•Prevent arbitrage

•Prevent leakage

•Preserve specific tax reliefs

Inland Revenue response - details

UK GAAP prevails where two connected companies adopt different accounting regimes

Legislation to preserve tax base such as section 472A providing that if under IFRS profits or losses on securities are taken to equity which are taken to profit under UK GAAP they remain taxable as if they had been taken to the income statement

Legislation to negate the effects of IFRS in areas such as research and development and hedging

The power to prescribe

Prescription defers taxation until the profit or loss on the hedged item is reflected in the income statement

FRED 34

Despite comments, FRED 34 is expected to come into force as drafted for 31 December 2004

Timing is driven by need to make it UK GAAP at transition to IFRS so that IFRS 4 – Insurance Contracts will apply it

What about tax under FRED 34?

Deferred tax effects only since no effect on Peak I

If PVIF can continue to be recognised:

- No deferred tax on it
- No grossing up of movement in income statement because tax applied in the calculations is not “tax expense” for IAS 12 purposes
- No grossing up in balance sheet unless a pre-tax discount rate is used

Pre-budget report

8 December 2004?

Election year?

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