Institute and Faculty of Actuaries

Life conference

Tax workshop – 21 November 2019
Riding the Waves

14 November 2019

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Riding the waves

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Wider landscape: US tax reform and OECD Digitalisation Project

Pillar 2 (released 8 November 2019)

Aims at a global minimum tax

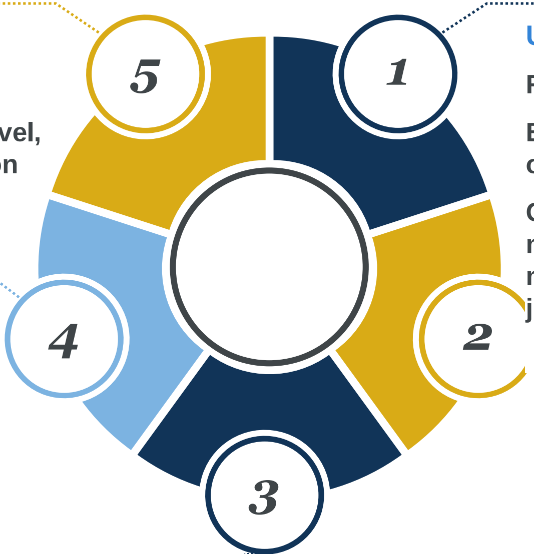
May operate by top-up taxes at shareholder level, or by denying tax deductions or withholding on payments to low tax jurisdictions

Pillar 1 (released 9 October 2019)

Businesses with customers in a jurisdiction may have to pay tax there – new rules to allocate profit

FS sector arguing for an FS exclusion

Aimed at consumer facing businesses – but will B2B be dragged in?



US tax reform

Reduction in corporate tax rates (35% to 21%)

BEAT (base erosion and anti-abuse tax) – limit on tax deductions to low-tax affiliates

GILTI (Global Intangible Low-Taxed Income) – measure to reduce incentive for US multinationals to shift profits to low or zero tax jurisdictions

Taxation of digital businesses

The problem: highly digitalised businesses reaching a mass of overseas consumers without presence – or tax in consumer jurisdiction

Topic not properly addressed by OECD's previous project on base profit erosion

OECD project has extended its reach

Proposals will apply to all businesses operating cross border

These proposals are not restricted to digital businesses

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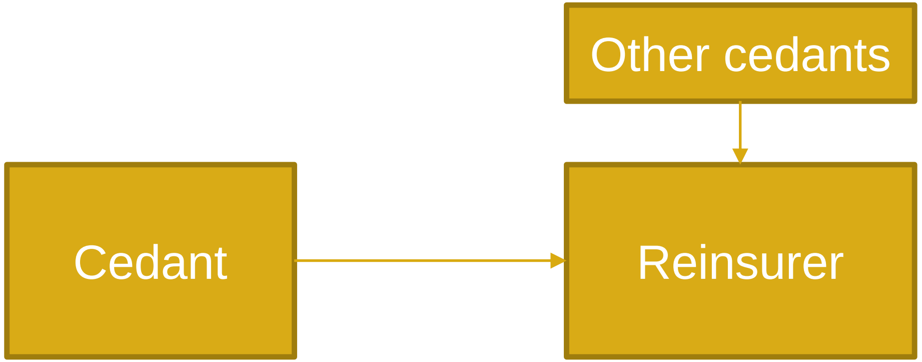
OECD project – Pillar 1 - what about reinsurance?



- Reinsurer pools risk
- It hold capital and has presence in its operating jurisdiction
- Pillar 1 allocates its profit potentially into cedant jurisdictions

What about existing transactions, where economics have been dealt with through up front via the premium? Can contracts be renegotiated (would this change trigger this)? How would the profits to be allocated be calculated given very different tax and accounting rules in different jurisdictions? Could such a rule disturb reinsurance markets?

Strategy: obtain FS exclusion from Pillar 1. But what about Pillar 2?

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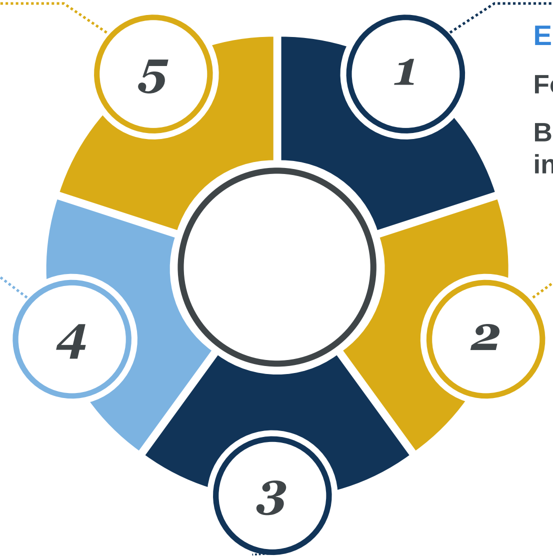
Back in the UK – significant political uncertainty



Election manifestos

Formal election manifestoes not yet published

But major parties have been signalling their intentions

Conservatives

Support for reducing the corporation tax rate further (no rate objective specified)

Possibility of rise in higher rate threshold to £80,000

Signalling around incentives for start ups and sympathy with dissatisfaction with inheritance tax system

Lib Dems

Replacement of corporation tax with a simpler business tax

25% flat rate on pension contributions

Reform of inheritance tax

Labour

Increase corporation tax (to 26%)

Reform of inheritance tax (reducing amount which can be passed between generations)

Financial transactions tax

Increase in capital gains tax (reversal of rate reductions)

Inclusive Ownership Fund

And meanwhile at the life insurers…

Brexit-related transactions and contingency planning

IFRS 17 programmes and finance change

Industry continues to reshape itself

Update on the typical tax profile of UK life companies

I minus E	I minus E continues its run-off with new business only written by a few companies, and consolidation reducing the number of companies subject to I minus E Continues to provide a very significant level of tax take for the Exchequer especially given high equity markets – though capital losses were seen in the 2018 year ends
Pension business	Pension business continues to increase especially due to large pension buy-ins and buy-outs There still appears to be very significant capacity in the buy-in and buy-out market IFRS 17 impact expected to be significant (see following slides)

- Number of companies subject to I minus E is reducing
- I minus E fluctuating in terms of gilt and bond price volatility reflecting uncertainty in the UK and elsewhere
- 2018 year end saw capital losses on equities – again showing effect of volatility

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Reminder of how IFRS 17 impacts corporate tax

The accounts are the tax base for insurance companies in the UK

Prima facie legal entities applying IFRS 17 will follow this for tax
No tax law change is needed to achieve this

Note - UK companies are taxed on legal entity accounts (not consolidated)

Some insurers are on IFRS and others are still on old UK GAAP

The UK tax code provides for changes due to accounting policy change to be taxed/relieved in the year when the policy is adopted.

The effect of the change all at once may be too disruptive

Companies and HMRC may both want a smoothed transition in

ABI have made proposals for a 10 year straight line spread – HMRC will start working groups in November

What is the effect of transition – immediate and 10 year spread? Case Study 1 - transition

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Case study: transition to IFRS 17 – assumptions

Asset/liability assumptions	IFRS4	IFRS 17
Assets	11,000	11,000
Liabilities	(9,500)	(10,500)
Net assets	1,500	500
Transitional reduction to equity		(1,000)

Assume pension business only writer – say a monoline annuity writer

Profit assumptions	Total	Existing business	New business
IFRS 4 profit	200	100	100
IFRS 17 profit	100	80	20

Highly simplified and illustrative – over time the profits should be the same by quantum, but we have assumed profits are back end loaded

Note - if there are group companies with profits or losses, the position may differ

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Case study: tax effect of transition in 2022

Central scenario				
	2021	2022	2023	2024
Profit before effect of transition	200	100	100	100
Profit taking into account transition		(900)	100	100
Loss carry back	(200)			
Offset of carried forward losses			(50)	(50)
Taxable profit after the effect of reliefs	0	0	50	50
Carry forward		(700)	(650)	(600)

1,000 reduction in equity is treated as a deduction in reaching taxable profit in 2022

50% rule slows down the utilisation of the brought forward losses. Ultimately the CSM amortises but the effect of the 50% rule causes a loss of fungibility, creating the risk that the overall tax liability is larger than absent the creation of CSM and reversal of it

This could also cause issues with DTA recoverability (depending on other sources of income as well such as new business, and timescales for recovery)

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Case study: tax effect of transition spread over 10 years

Central scenario				
	2021	2022	2023	2024
Profit before effect of transition	200	100	100	100
Profit taking into account transition (£100m deduction each year)		0	0	0
Loss carry back	0			
Offset of carried forward losses				
Taxable profit after the effect of reliefs	200	0	0	0
Transitional amounts to be deducted in the future		900	800	700

1,000 reduction in equity is treated as a deduction in reaching taxable profit in equal amounts from 2022 over a 10 year period

Profit is reduced to zero by 100 deduction each year

In practice it's unlikely that the 1/10th would precisely match the profit. The profit may be volatile. If the profit is less than the 1/10th, carried forward losses will hit the 50% rule.

If the profit does exceed the 1/10th, the company is taxpaying despite the transition deduction

The high level message is that although the spreading effectively denies the carry back benefit into 2021, the transitional loss being spread reduces the risk of the 50% applying

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Case study: Solvency II tax before IFRS 17

IFRS4 B/sheet		SII B/sheet		
Assets	11,000	Assets	11,000	
		BEL (post MA)		(8,500)
		RM		(2,000)
		TMTP		1,500
Liabilities	(9,500)	Liabilities	(9,000)	
Net assets	1,500	Net assets	2,000	
Difference/DT			500	100
LACDT				
Offset v DTL			(500)	(100)
Offset v prior year			(200)	(40)
Offset v future profit (3 years)			(300)	(60)
Unused			(1,000)	(200)

TMTP running off over a 16 year period – DTL position in base reducing

Shock loss			
Shock loss	2,000		
Underwriting		1,000	
Investment		1,000	
	Total	Existing	New
IFRS 4 profit	200	100	100
IFRS 17 profit	100	80	20

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Case study: impact of IFRS 17 on SII tax

IFRS4		IFRS 17	SII		
Assets	11,000	11,000	Assets	11,000	
			BEL (post MA)		(8,500)
			RM		(2,000)
			TMTP		1,500
Liabilities	(9,500)	(10,500)	Liabilities	(9,000)	
Net assets	1,500	500	Net assets	2,000	
Difference		(1,000)		1,500	
DTA/DTL		(200)		300	100
LACDT					
Offset v DTL				(500)	(100)
Offset v PY				(100)	(20)
Future profits				(60)	(12)
Unused				(1,340)	(268)

Shock loss			
Shock loss	2,000		
Underwriting		1,000	CSM
Investment		1,000	P&L
	Total	Existing	New
IFRS 4 profit	200	100	100
IFRS 17 profit	100	80	20

High level message – the Solvency II base balance sheet tax may be broadly unchanged by IFRS 17

But on an ongoing basis LACDT could be impacted e.g. due to change in carry back and carry forward

Carry back here is highly illustrative – to show it may change depending on various factors, but may well be less than under IFRS 4

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IFRS 17 – update on the "I minus E issue"

The problem: where the IFRS 17 insurance cash-flows in the BEL take into account the fact that amounts due to policyholders will be reduced for expected future policyholder tax, this gives rise to a profit – unless the tax liability the company is expected to have can also be recognised in the cash-flows. If not, there is a mismatch. So why can't the tax liability be recognised?

(i) transaction-based taxes (such as premium taxes, value added taxes and goods and services taxes) and levies…. that arise directly from existing insurance contracts, or that can be attributed to them on a reasonable and consistent basis.

(j) payments by the insurer in a fiduciary capacity to meet tax obligations incurred by the policyholder, and related receipts

(IFRS Appendix B Paragraph B65).

How much does this matter? Is it a presentational issue or also a real tax issue? Will representations to the IASB to clarify this be successful?

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IFRS 17 – update on the "I minus E issue"

	Net products	Comments
Linked investment return	300	Assume fully taxable at 20% in I minus E
Accounts presentation		
AMC	102	Broadly 1% x unit fund
Charge to policyholders	60	Normally today's accounting would not include a prediction for this in relation to future investment return – it is year by year
Profit before tax	162	PBT is grossed up for the charges in relation to tax – tax is in the tax line
Tax at the CT rate (19%)	(24)	Note the tax regime determines how the tax is split between policyholder and shareholder tax (not detailed here)
Tax at 20%	(35)	
Profit after tax (SH and PH)	103	Iterated

IFRS 17 – update on the "I minus E issue"

	Tax included	Tax not included	Comments
BEL and CSM (AMC only)	929	929	NPV of the £102 and future equivalents
Future tax charges	490	490	NPV of the £60 and future equivalents – would increase CSM in second example
Future tax liabilities	(490)		NPV of the £60 and future equivalents
Insurance service income	90	137	CSM amortisation
Insurance service expense	60		Tax needs to be moved from within PBT to the tax line
Profit before tax	150	137	Difference is not dramatic on this example – and it's timing – but what about different scenarios?
Tax at CT rate	(21)	(18)	
I-E tax balance	(37)	(40)	
Profit after tax	92	79	

Key take away:

Whilst the impacts do not appear major on this slide, different scenarios e.g. experience may produce very different results

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IFRS 17 – update on the “I minus E issue”

How material is this point?

Does the standard need adjusting?

Could a change in the standard have unexpected impacts?

Is the approach in the standard right or wrong in principle?

Could this be addressed in guidance?

Can the accounting profession take a pragmatic view?

Shouldn’t the standard be interpreted in a sensible manner?

Case Study: Impact of regulatory capital securities Quick refresher!

Solvency II eligible capital (illustrative)

SCR

Tier 1

Restricted Tier 1 (rT1)

Tier 2

Tier 3

Max 20% of total Tier 1

Max Tier 2 50%

Max Tier 3 15%

Substantially excess of assets over liabilities

Other permanent funds that are fully loss absorbing on a going-concern basis such as preference shares or debt that converts to ordinary shares or is written off when capital cover for solvency requirements falls to defined levels

Subordinated debt

Other ancillary capital (subject to regulator's approval) and deferred tax assets

rT1 debt would have to convert to ordinary shares or be written off well before there is a risk to policyholder or creditor payments in order to qualify as rT1

Note: other MCR related restrictions also apply

Case Study: Impact of regulatory capital securities legislation on Solvency II

Hybrid capital securities rules apply to all companies from 1 January 2019 (replacing some broader previous rules)

- Should apply to many but not all debt Tier 1 and Tier 2 regulatory debt
- Main objective is to preserve tax features of debt instruments despite loss-absorbent characteristics of debt which is Tier 1 or Tier 2
- But the new rules are more restrictive – for example Restricted Tier 1 debt principal write-down is much more likely to be taxable (under the old rules this was not the case)
- Issues have also been emerging in relation to certain terms relating to convertibles (see next slide)

Why does this cause an issue in Solvency?

It became clear that rT1 write-down securities would be likely to be taxable on write-down

PRA issued a CP (subsequently PS 4/19) requiring companies to reduce the Tier 1 value of the debt by the tax payable on the write-down

This applied to new issuances from February 2019 – existing issuances were considered on a case by case basis

This probably means that write-down securities are unattractive from a Solvency II perspective

So are convertibles a safe alternative?

Case Study: Impact of regulatory capital securities legislation on Solvency II

Convertible Rt1

- There is no specific provision in the hybrid capital securities rules regarding conversion of debt to equity
- There is an ordinary corporation tax rule which protects the conversion of debt to equity
- But convertible Rt1 tends include a CSO clause – an option for the debt issuer to compel note holders to sell shares issued on conversion – this is there for commercial purposes e.g. anti-dilution
- HMRC take the view that a CSO clause may prevent the conversion of debt to equity rule from applying
- The effect would be a potential tax charge on conversion

PRA issued CP 26/19 on conversion of rT1 with a CSO clause

❖ For new issues of RT1 with conversion features and a CSO clause, the Tier 1 value of the debt must be reduced by the maximum tax charge on conversion i.e. assuming that the debt/equity exemption does not apply

❖ The suggestion is that this is not to be the case where an "independent tax opinion from an appropriately qualified individual" is provided stating that "no tax will be payable on trigger"

❖ Again, existing issuances will be looked at on a case by case basis.

❖ Consultation closes on 13 January 2020

"[HMRC] explain that this is because a realistic view of the facts is that the release of debt is not in consideration for shares but in consideration for cash"

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Riding the waves

How to stay on top of it all

Things are moving fast
Staying close to the lobbying process - but also observing the way the tide is turning
Not time for head in the sand strategy

Making assumptions

Impacts of these types of changes need to be quantified
The timetable won't wait for things to be certain
Modelling needs to be done

Reinvention is the way to win

Tax is more now than compliance and advisory
Companies need tax to be switched on and working with the business understand financial impacts – these changes may go to the business strategy itself

Tidal waves in the tax world

- US tax reform, implemented at top speed, and altering the landscape between the US and the rest of the world after many years
- The OECD project – ripping up the international tax rulebook as we know it, being described as the biggest changes for 50 years
- IFRS 17, changing the accounting basis for insurance and in many jurisdictions the tax basis
- Tax teams under cost pressures

Questions

Comments

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