Life conference

Tax workshop – November 23rd 2017
Winds of change

Contents

Winds of change

- Is the tax regime keeping pace with the change which has been sweeping through the life sector in the UK?
- IFRS 17 – will it be a tsunami for tax, or a gentle wave?
- Mainstream tax change can also have unexpected outcomes (2 case studies):
  - A problem of understanding the business model – interest rules; and
  - A problem of understanding the regulatory position – loss restriction rules.
- What to watch? Personal taxes.

Instead of using the terms “BLAGAB” and “non-BLAGAB” for I minus E business and gross roll-up business, we will predominantly use “Life” and “Pension” as a proxy, for simplicity.

The slow demise of I minus E

With profits	With profits suffered changes to the regulatory environment and adverse press comment. With profit mortgage endowments suffered critical press comment on low bonuses and failure to repay mortgages at maturity. Most with-profit funds are closed to new business.
Unit linked endowment policies	Mortgage endowments also suffered critical press comment on low growth resulting in failure to repay mortgages at maturity. Consequently most unit linked endowment business is closed to new business.
Onshore bonds	Some limited sales of bond business but volumes are significantly down on historical levels.
Pre 2013 protection	All post 2013 protection business now taxed on a profits basis like pension business. Remaining pre 2013 business is no longer contributing significant expense deductions in the I minus E computation.

- Life assurance business has evolved over many years and the historical dominance of life business taxed on an I minus E basis has been largely replaced with business taxed on a profits basis (such as pensions).
- Yet back books still hold substantial assets generating substantial taxable income and gains on equities and property. The change to protection business prevents any significant expense deduction so I minus E tax remains very material.

But I minus E tax take is very much driven by rising prices in bonds and equity gains – how long will this significant tax contribution last?

What is the future for I minus E?

Institute and Faculty of Actuaries

The shift towards pensions/gross profit business…

Protection	New Protection products (from 1 Jan 2013) are taxed in the same way as pension business under the new life tax regime.
PHI	PHI is taxed in the same way as pension business under the new life tax regime.
Pensions accumulation	Auto-enrolment encouraging new pension business; tax relief still available on significant contributions to pension schemes.
Annuity business	Rise of major buy-outs from DB pension schemes. Specialist annuity provision e.g. impaired lives. Still a significant annuity market from pensions accumulation policies. Large existing annuity books …though recent pension freedom legislation may reduce new business flow.

As I minus E business falls as a proportion, more and more companies will move to being taxed on a profit basis.

Institute and Faculty of Actuaries

The overall picture today

I minus E	Currently there is significant tax take from I minus E – cash tax to HMRC Does this tax take make sense or is it market bubble? What will happen if interest rates increase?
Shareholder share	What drives Life profit emergence, as compared with I minus E?
Pensions (Non-BLAGAB) profit	1/9th emergence smooth May be volatility depending on liability basis in stat accounts (Solvency I based still) v asset values Up-front profit on annuities and Protection

"Shareholder fund"?	HMRC challenging concept of anything in the life company outside the long term business - surplus assets have to be in BLAGAB/non-BLAGAB
Structural assets – taxed separately	HMRC challenging these – limiting them to subsidiaries and debt with subs

What will this look like in a few years' time?

Institute and Faculty of Actuaries

The overall picture – how might it change

Life profits Pension profits	Companies could move into a full CT rate x profit position, with negative I minus E This assumes I minus E losses aren't necessarily reflected in true profit (as I minus E is one sided) Effects could be unpredictable if there are also real trade losses in BLAGAB and non-BLAGAB or in both
Negative income (XSE)	This tax asset would be lost if a company is moved to full CT rate x profit position

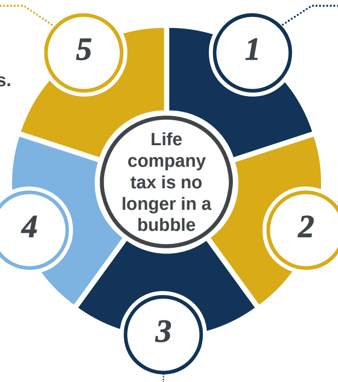
- If I minus E is perceived to become an arcane tax could it be removed? What would this mean for companies?

- What are the implications of falling I minus E profit for life companies?
- If income is less than expenses or even negative then the losses (XSE) are carried forward to relieve future positives.
- Or are they?

Would the picture be temporary or permanent?

Institute and Faculty of Actuaries

Wider tax rules – Life company tax under siege



1 Political and vote-winning policies in personal tax.

Inheritance tax (e.g. property to children)
Pension freedoms.

Reduction in benefits of pensions for higher earners.

2 Encouragement of savings – But not via life policies.

Dividend tax breaks

LISA

Increases in ISA limits

3 Domestic political agenda to ensure that big companies pay tax.

Led to rules on corporate loss restriction (see later slide).

4 International and domestic agenda to stop companies avoiding tax – impacts on corporate tax policy.

Led to interest rules (see next slide).

5 Desire of the Office of Tax Simplification to decommission outdated rules.

Eye on the personal tax treatment of life savings.

Institute and Faculty of Actuaries

Case Study 1. Interest – The pragmatic solution which almost creates a disaster

Basic rule – to restrict interest deductions to 30% of the company's profits (as adjusted for interest and tax)

Why?

Part of an international (OECD) project to drop "base erosion of profits" for tax (BEPS)

How would this apply to insurance companies and banks, where interest forms an inherent part of their business?

Previously there was a debt cap in UK legislation but banks and insurers were largely exempt from this

Solution – rule only applies if there is overall net interest payable in the UK group. As this takes into account interest on assets in the insurance funds, that will never be the case, so problem solved….right?

Legislation defined interest to include market value movements on gilts & bonds – so for life funds if the asset side went down, there would be an interest cost

Restricting reductions in asset values for tax purposes (disregarding liabilities) would potentially cause catastrophic mismatches for tax

HMRC ultimately understood the problem and permit insurers to make a one-off "amortised cost election" which effectively excludes market value movements from the test

This exercise shows it is critically important to explain the way insurance works to HMRC and HM Treasury

Institute and Faculty of Actuaries

Case Study 2. Loss restriction rules – An unexpected regulatory impact

Old (very longstanding) UK rules

Tax loss incurred in a company in a year

- Carry back against profits of previous year in same company
- Carry forward indefinitely against profits of the same company
- Offset against profits of other companies in the group only in same year (known as group relief)

Points to note with the old regime:

1. Some companies with large losses carried forward were not paying any tax at all for a long time – considered politically unacceptable.
2. Trapped losses – incurred in a holding company with debt and unable to be surrendered against another group company in-year.
3. Solvency II either prohibits (standard formula) or makes very difficult (internal model) the recognition of group relief.

Institute and Faculty of Actuaries

Case Study 2. Loss restriction rules – An unexpected regulatory impact (cont'd)

New rules (announced with no pre-warning)

Tax loss incurred in a company in a year

- Carry back against profits of previous year in same company – unchanged
- Carry forward indefinitely against 50% of the profits of the companies in the group
- Offset against profits of other companies in the group in the same year

Points to note with the new regime:

1. It was the intention to impact timing not quantum of tax – but the law certainly doesn't prevent there being a permanent effect
2. Mitigates the trapped losses problem (welcome to many groups)
3. Doesn't apply to I minus E losses (XSE) though it does to BLAGAB trade losses – complicated point not covered here
4. Most serious effect if there is a sudden loss e.g. on Solvency II – resolved after significant lobbying with special shock loss relief from 50%

Shows the need for liaison between the regulator and HMT/HMRC

Probably none of them understood significance of LACDT offset against deferred tax liabilities in the Solvency II balance sheet

Institute and Faculty of Actuaries

IFRS 17 – tsunami or breeze?

Tax is calculated using the legal entity accounts in the UK	Only changes in entity accounts will make a direct difference for tax – not consolidated accounts Impact depends on the extent to which IFRS is used for the tax base
Investment contracts	Investment contracts not accounted for as insurance should not be impacted by IFRS 17 This is a lot of unit linked in the UK – though some unit linked is accounted for as insurance
Companies on UK GAAP	Companies on UK GAAP will not currently be impacted by IFRS 17 – there are still some big examples of this But the UK's accounting regulator may in due course incorporate it Will companies on UK GAAP be happy to keep the Solvency I link?
IFRS consolidators	Groups consolidating into IFRS will still need to convert results on IFRS 17 even if subsidiaries remain on local GAAP – this can have significant tax reporting implications including financial impacts

There are a lot of scenarios but the key one is where the entity prepares its accounts on IFRS so is directly impacted

Institute and Faculty of Actuaries

IFRS 17 – tsunami or breeze? (cont'd)

Company writing non profit pension annuity business (open) – today	Follows the accounts – assets are mark to market, liabilities broadly follow Solvency I – can be very volatile Profits on new contracts tend to be recognised earlier (depending on accounting policy) Large LACDT typically recognised in Solvency II v transitional/MA deferred tax liability and carry back
What will change?	Assets are still mark to market but liabilities will be on the IFRS 17 basis (BEL + RA + CSM) Ongoing profit profile will change – profits deferred rather than recognised up-front Will there be a step change at transition, either a one-off profit or a one-off loss?

Tax will follow the profit in the accounts, assuming the law remains unchanged

Current tax law picks up the difference from reserves and taxes or relieves it immediately i.e. in the year of change – companies are likely to lobby HMRC for a 10 year spread effect

This analysis needs to be done per IFRS legal entity in order to get the full tax picture especially on transition

With-profits tax profile is likely to change (currently smoothed in the accounts and not recognised until bonus declarations are made)

Institute and Faculty of Actuaries

IFRS 17 – tsunami or breeze? (cont'd) – Strategic points

What are other countries in the world doing?	Will tax authorities accept a basis which systematically defers profit?	Would a Solvency II basis have been better?	Might this trigger a review of the life tax regime again?

So what's next?

What have HMRC said about all this?

Institute and Faculty of Actuaries

27 November 2017 13

What else to look out for?

Budget announcements	Watch this space – Budget on the 22nd so we will update on the day….
US tax reform	Especially if your group has affiliates in the US, and connected transactions – there are some very problematic proposals for life insurance
Brexit	Tax consequences of transactions required as a result of Brexit

Other current tax themes

- Increased compliance burden - (FATCA, CRS. CDOT, CCO, CBCR, offshore structures – the list is only going to increase)
- Litigation and arguments about VAT exemptions and recovery bases
- Transparency – publication of tax strategy
- Tax & digital agenda – pressure to update technology underpinning tax from all sides (including the tax authorities)

Institute and Faculty of Actuaries

27 November 2017 14

Questions

Comments

The views expressed in this presentation are those of invited contributors and not necessarily those of the IFoA. The IFoA do not endorse any of the views stated, nor any claims or representations made in this presentation. The IFoA, the contributors and the organisations they represent accept no responsibility or liability to any person for loss or damage suffered as a consequence of their placing reliance upon any view, claim or representation made in this presentation.

The information and expressions of opinion contained in this publication are not intended to be a comprehensive study, do not constitute actuarial advice, tax advice or professional advice of any nature and should not be treated as a substitute for specific advice concerning individual situations. On no account may any part of this presentation be reproduced without the written permission of the IFoA.

Institute and Faculty of Actuaries