



HM TREASURY



HM Revenue
& Customs

Solvency II and the taxation of insurance companies

March 2010



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<p>Subject of this consultation</p> <p>Scope of this consultation</p>	<p>This consultation is about the impact of the EU Solvency II Directive on the taxation of insurance companies</p> <p>Solvency II is about the regulation of insurance companies. However, this consultation is not about regulation, but about tax consequences of the expected regulatory changes. Its purpose is to explore the implications of a proposed move to using company accounts as the basis for computing trading profits of life companies; to consider the tax impact of Solvency II on reserves maintained by general insurance companies; and to canvas views on desirability of wider reform to the taxation of life companies</p> <p>A consultation stage Impact Assessment is attached in Annex B</p>
<p>Impact Assessment</p> <p>Who should read this</p>	<p>Insurance industry representative bodies; individual insurers; professional bodies; industry advisers; the Financial Services Authority</p>
<p>Duration</p> <p>Enquiries</p>	<p>10 March to 2 June 2010 (12 weeks)</p> <p>Enquiries should be made to Andy Stewardson on 0207 147 2600 or at andy.stewardson@hmrc.gsi.gov.uk</p>
<p>How to respond</p>	<p>By email to: andy.stewardson@hmrc.gsi.gov.uk or by post to: Andy Stewardson HM Revenue & Customs Room 3C/06 100 Parliament Street London SW1A 2BQ</p>
<p>Additional ways to become involved</p> <p>After the consultation</p>	<p>HM Treasury (HMT) and HM Revenue & Customs (HMRC) will be happy to hold discussions with interested parties.</p> <p>Responses will be used as the basis for further discussions with interested parties, with a view to developing and refining the tax response to Solvency II. In view of the Solvency II timetable, it is envisaged that legislation will be in the Finance Bill 2011.</p>
<p>Previous engagement</p>	<p>HMT and HMRC have been engaged in informal discussion with stakeholders since summer 2009. Much of the content of this consultation is shaped by those discussions. A number of written representations have been received, and these are also reflected in this document.</p>

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1

Introduction

Background

1.1 In July 2009, the Government published a joint report with the insurance industry outlining its vision for 2020. That vision is for the UK to be the **leading global insurance centre with an unsurpassed reputation for excellence, a deep and constructive relationship with its customers and a close and effective partnership with the Government**. The vision forms the backdrop to our work in considering appropriate responses to the significant tax changes that the EU Solvency II Directive will bring for UK insurers.

1.2 Solvency II is an EU-wide initiative, currently scheduled to come into effect in October 2012. It aims to introduce a modernised, risk-based approach to the regulation of insurance companies whilst at the same time ensuring appropriate protection for policyholders. The UK is actively engaging with the Commission to ensure that the UK's views are heard and its interests protected.

Purpose

1.3 The purpose of this consultation document is not to discuss those wider issues of industry regulation. Rather, it focuses specifically on the implications of the Directive for the taxation of UK insurers. In particular, it invites comment from interested parties in exploring the following two areas as a direct response to Solvency II:

- The technical and transitional issues arising from a move to a new approach, based on statutory company accounts, to the calculation of trading profits for life companies.
- The tax consequences of Solvency II on the general insurance industry, and Lloyd's of London, and in particular the impact on the reserves maintained and the treatment of claims equalisation reserves.

In addition, but not in direct response to Solvency II, the consultation takes the opportunity to:

- Consider possibilities for wider ranging reform of the life insurance taxation regime.

The Consultation

1.4 This consultation document is published jointly by HM Treasury and HM Revenue & Customs. It does not in general set out detailed proposals, although where initial assumptions have been made about what proposals are appropriate, it sets these out. The main exception to this is in Chapter 2, which makes clear that under Solvency II statutory accounts are proposed as the basis for the computation of life assurance business trading profits.

1.5 The document invites comment on specific tax questions in which the Government has a particular interest. However, there is no intention that respondents should be constrained to those questions. The taxation implications of Solvency II are wide ranging and, in some areas, fundamental; part of the purpose of this document is to scope the extent of those implications.

The Government therefore welcomes views on subjects which are not directly raised, but which respondents consider important to a full consideration of the issues.

1.6 HMRC and HM Treasury have been in informal discussions with the insurance industry and others since July 2009, and significant progress has been made; the Government is grateful to those who have contributed. Much of what is in this document reflects the direction those discussions have taken and specific areas of concern which have been raised. In some areas formal and informal representations have been made. This document offers an opportunity for interested parties to update, expand, refine or formalise representations already made. It also invites comment from a wider range of potential respondents.

How to Respond

1.7 The consultation will run for 12 weeks from 10 March to 2 June 2010.

1.8 A summary of specific questions in this consultation is included at Chapter 5.

1.9 Responses should be sent by e-mail to: andy.stewardson@hmrc.gsi.gov.uk

or by post to:

Andy Stewardson
HM Revenue & Customs
Room 3C/06
100 Parliament Street
London
SW1A 2BQ

or by fax to: 0207 147 2641

Telephone enquiries: 0207 147 2600

1.10 Paper copies of this document may be obtained free of charge from the above address. All responses will be acknowledged, but it will not be possible to give substantive replies to individual representations.

Confidentiality

1.11 Information provided in response to this consultation, including personal information, may be published or disclosed in accordance with the access to information regimes. These are primarily the Freedom of Information Act 2000 (FOIA), the Data Protection Act 1998 (DPA) and the Environmental Information Regulations 2004.

1.12 If you want the information that you provide to be treated as confidential, please be aware that, under the FOIA, there is a statutory Code of Practice with which public authorities must comply and which deals with, amongst other things, obligations of confidence. In view of this it would be helpful if you could explain why you regard the information you have provided as confidential. If a request for disclosure of the information is received full account will be taken of your explanation, but an assurance cannot be given that confidentiality can be maintained in all circumstances. An automatic confidentiality disclaimer generated by your IT system will not, of itself, be regarded as binding on HMRC or HM Treasury.

Impact Assessment

1.13 A consultation stage Impact Assessment is attached at Annex B. Respondents are invited in particular to include in their responses information regarding the likely administrative and compliance costs or savings which would attach to any proposal or suggestion addressed.

Transitional Issues

1.14 Some specific transitional points are addressed in this document. It does not contain a comprehensive consideration of transition because the ultimate form of a new tax regime for insurers is not yet clear. However, if respondents wish to make representations in this area, the Government will be glad to receive them.

2

A new basis for the calculation of trading profits

An Accounts Basis for the Calculation of Trading Profits

2.1 At present the tax regime for life insurers is explicitly based on the regulatory return made to the FSA. Solvency II will change the format of the forms submitted and do away with a number of key concepts on which returns are currently based. One of these concepts is the calculation of regulatory surplus – that is, the excess of value of assets over value of liabilities in the Long Term Insurance Fund (LTIF). Currently, the trading profit result is based on the surplus arising in the year as reported in the FSA return in accordance with HMRC’s Statement of Practice 4/95. The strong indication is that, under Solvency II regulation, no such surplus will be reported. Draft forms, issued with CEIOPS consultation paper 58 on 2 July 2009, include no equivalent figure of surplus. Computations of the investment return which enters into the computation of gross roll-up business (GRB) trade profits are also based on figures from the current FSA return.

2.2 It is therefore apparent that a replacement methodology is required for the calculation of trading profits of life insurers.

2.3 The Government has been conducting informal discussions with a wide range of stakeholders since the summer of 2009. These discussions have centred on identifying possible methodologies and their implications. Consideration was given to three options – no other possibilities were identified by any party:

- To continue with the current basis (but without a return to regulators which would support that mechanism).
- To use a profit figure, appropriately adjusted, from the Solvency II regulatory return.
- To use a profit figure, appropriately adjusted, from the statutory accounts.

2.4 The first of these was thought by both industry and Government to impose an unwarranted burden on business. It would require companies to maintain an additional set of actuarial calculations for tax purposes only.

2.5 There was wide acceptance that basing the tax calculation on a Solvency II return would on balance be undesirable because of the uncertainties around that return and its likely focus. The final form and content of the return will not be resolved until it is too late for Government to enact legislation in time for companies to prepare for implementation. Further, initial draft forms issued by CEIOPS suggest that the profit figure returned might not represent a reconciliation of the opening and closing balance sheets for any period. It is clear that the purpose of the Solvency II returns will be to focus on capital adequacy rather any measure of profits, and that profit measurement is unlikely to be a priority for its designers. Finally, with a fundamentally new regime such as Solvency II, it is to be expected that there will be adjustments, not predictable at present, in its early stages. Solvency II will be subject to post-implementation review, and this process could result in significant changes.

2.6 The expected convergence of UK GAAP with IFRS (see paragraph 2.10 below) means that all UK insurance companies, and indeed other companies, are likely to produce accounts on IFRS lines, possibly from 2012. IFRS accounts would provide a coherent and audited set of numbers,

which would have a profit figure as one of their key outputs (as indeed would UK GAAP accounts). They are also figures which companies will have to produce irrespective of any tax considerations.

2.7 The Government proposes that the appropriate starting point for the calculation of a life company's trading profits in light of the introduction of Solvency II should be its statutory company accounts. It is recognised however that this is not an easy option, not least because of anticipated accounting changes. There are a number of issues which need to be addressed before the detail of a new regime can be worked out, and the remainder of this Chapter aims to explore those issues. They can be grouped as follows:

- Accounting developments
- Tax adjustments to accounts profits
- How will the profit figure be used?
- Apportionments

Accounting Developments

Source of profit figure under an accounts basis

2.8 As set out above, the Government proposes that following the implementation of Solvency II life assurance trade profits should be based on the profit reported in the company's financial statements. UK life companies may currently prepare their financial statements using either UK GAAP or IFRS and under this proposal either basis of accounting would be acceptable. On this basis, the starting point for the determination of the life assurance trade profits would be, as it is for non-insurance companies:

- Profit on ordinary activities before tax attributable to shareholders as reported in the Non-Technical Account, for companies applying UK GAAP.
- Profit before tax attributable to shareholders as reported in the Income Statement, for companies applying IFRS.

2.9 The expectation is that companies would not need to change their accounting policies as a result of this proposal. For companies applying UK GAAP, the expectation is that all life companies would continue to comply with the ABI SORP.

Comment is welcome on the proposed starting point for the determination of life assurance trade profits, including whether there might be circumstances where a different figure from the accounts would be more appropriate (for example to take account of exceptional items).

ASB Proposals on the Future of UK GAAP

2.10 In August 2009 the UK Accounting Standards Board issued a consultation paper containing proposals on the future of UK GAAP. The essence of the proposals is that 'publicly accountable entities' would no longer be permitted to apply UK GAAP but would be required to apply full IFRS. The Government's understanding is that life companies would be deemed to qualify as 'publicly accountable entities' and that all life companies would therefore be required to apply full IFRS. The ASB also proposed that this change should take effect from 2012, although some commentators regard this timetable as ambitious. The overall implication, therefore, is that all UK life companies will need to prepare their financial statements under full IFRS from 2012 or possibly from 2013 or a later year.

Comment is welcome on the implications for life companies of the ASB’s proposals, and in particular on the impact of the ASB’s proposed timetable and on the question as to whether there any categories of life company which would not fall to be classified as ‘publicly accountable’.

Impact of Solvency II on Financial Statements Technical Provisions

2.11 Under both UK GAAP and current IFRS, the mathematical reserves determined for regulatory purposes drive the measurement of the technical provisions included in the financial statements. If the basis of those mathematical reserves for regulatory purposes changes as a result of Solvency II, then the Government understands that companies might choose, or be required, to reflect the revised reserves in their financial statements, potentially leading to significant changes in the basis and level of technical provisions in the financial statements.

Comment is welcome on the potential impact on the accounts of likely changes in technical provisions for solvency purposes. In particular, for companies applying UK GAAP or current IFRS, do you consider that technical provisions in financial statements will need to change to reflect changes in mathematical reserves for Solvency purposes, or could this remain a matter of choice?

IFRS for Insurance Contracts – Phase II

2.12 The IASB is currently engaged in a project to devise and issue a comprehensive accounting standard on accounting for insurance contracts. The Government’s understanding is that an Exposure Draft is due to be issued in May 2010 and that a final standard is expected to be issued in June 2011. The new accounting standard on insurance contracts (IFRS 4 Phase II) is expected to result in fundamental changes to the way in which insurance contracts are accounted for by insurers.

2.13 Although earlier expectations were that the IFRS 4 Phase II standard would be effective from 2012, commentators have suggested that the standard is unlikely to be effective before accounting periods beginning on or after 1 January 2013 and more probably not until 2014 or later.

2.14 The interaction of the proposed and potential changes described above means that the future basis of the financial statements of life companies is uncertain in several major respects. It is possible that these and other changes will occur in the same or in successive periods. For example, the following scenario might arise:

Basis for life assurance trade profits			
2011	2012	2013	2014
FSA Return	Accounts	Accounts	Accounts
Solvency 1	UK GAAP	IFRS 4 Phase 1	IFRS 4 Phase II

2.15 Consideration therefore needs to be given to whether special transitional measures would be required for:

- (a) the initial change of basis from the FSA Return to the financial statements (see further details below); and
- (b) any subsequent changes in the basis of the financial statements, e.g. from UK GAAP to IFRS or from IFRS Phase I to IFRS Phase II.

Comment is welcome on whether special transitional measures would be appropriate for the potential subsequent changes in basis outlined under (b) above, or whether the normal rules for

dealing with changes in accounting policies would be sufficient to deal with such potential changes.

Comment is also welcome on the potential impact on life companies of more than one major change in the basis of life assurance trade profits in quick succession, and on ways in which any adverse impact might be mitigated.

Transition from FSA Return to Accounts Basis

2.16 The uncertainties over the precise accounting basis that life companies will be using at the time Solvency II is implemented mean that it is difficult to assess the likely impact of a switch to an accounts basis for the purposes of determining life assurance trade profits. For this reason transitional measures are likely to be extremely important.

2.17 Representations made to date suggest that, where significant tax effective adjustments are likely to arise on transition to an accounts basis, there may be a case for introducing specific measures to deal with them. It has been suggested that such measures might, for example, involve spreading the tax impact of the transitional adjustment over a specified number of years.

2.18 Particular areas where this might be relevant include:

- Technical provisions (mathematical reserves)
- Financial assets held as investments
- Deferred acquisition costs ('DAC')

Comment is welcome on the need, and justification, for introducing specific transitional measures to deal with step changes in the values of assets and liabilities, including comment on what specific adjustments might be appropriate.

Tax Adjustments to Accounts Profits

2.19 For tax purposes the trading profits of companies resident in the UK must in general be calculated in accordance with generally accepted accounting principles as specified in Section 46(1) Corporation Tax Act 2009. Those profits may then be subject to certain adjustments permitted or required by statute to arrive at the ultimately taxable figure. By contrast, profits of life companies, exceptionally, are currently based on the regulatory surplus. If life companies are to be subjected to Section 46(1), then it will be necessary to consider what statutory adjustments to the accounting profit might be appropriate. This is relevant in the case of:

- Tax adjustments which do not currently apply to life companies.
- Possible sector-specific adjustments which might be appropriate for life insurers, but which do not apply to other companies.

Tax Adjustments not currently applied to Life Companies

2.20 There are some parts of the tax code which apply to the generality of trading companies, but which are specifically modified or disapplied in the case of life companies. Representation has been received suggesting that it could be timely to explore how these rules should apply to life companies.

In what instances might it be appropriate to reconsider the application of general tax rules to life companies?

How might the application of such rules be changed, and why?

Possible Sector-Specific Adjustments to Accounting Profits

2.21 In the Government's view, profits disclosed in audited financial statements should in general be the basis for taxation. This is the basis applied to companies outside the insurance sector, and the financial statements are certified as presenting a "true and fair" view of a company's financial position. Any adjustment to these profits for tax purposes should be based on principles derived from settled case law or dictated by generally applicable legislation in pursuit of particular policy objectives.

2.22 It follows that in the Government's view, if any sector-specific adjustment to accounting profit is to be considered, there needs to be a clear and strong case to support it. So any such case should be:

- Justified by reference to clear and relevant principles.
- Clearly distinguished from other sectors.
- Supported by evidence.

This applies especially where any suggestion is made which would cut across established general principles for computing tax profits. It is however worth making a distinction here between adjustments to the ongoing basis of taxation and temporary adjustments that might be necessary as part of any transition.

2.23 The Government has received suggestions from industry that there are features of the life insurance industry which would justify special rules, and these are mentioned below.

Volatility

2.24 There is a widely held view that a tax result based on unadjusted financial statements (or indeed on Solvency II returns) is likely to be more volatile than at present. The Government understands the main reason for this is that asset values, and therefore investment returns, will in general be "marked to market", and therefore subject to short term fluctuations. But this volatility will not apply equally to all classes of business.

Volatility – With-profits Business

2.25 The essence of with-profits (also known as "participating") business is that surpluses (excesses of assets over liabilities) are shared between policyholders and shareholders. For with-profits business, the regulatory "recognitions basis" currently permits insurers to recognise asset values at less than the full value which would be admissible under the regulatory rules. Effectively gains made in a period can be deferred, to be recognised and taxed in a later period (and in fact may never be recognised if they are subsequently reversed due to market movements). As a consequence recognition of increases in value and the taxation of that increase is deferred. This smoothing mechanism is an important commercial feature of this type of business, with the benefit to policyholders that they are less exposed to the vagaries of short term market movements when the terminal bonus to be paid is determined on maturity.

2.26 UK GAAP encompasses the concept of a Fund for Future Appropriations (FFA), and IFRS currently uses a similar mechanism, the Unallocated Distributable Surplus (UDS). These accounting concepts fulfil a similar role to the regulatory smoothing mechanism described above. Amounts held in the FFA/UDS are not recognised as profits. The company has a degree of discretion over when they are ultimately allocated and released for distribution to policyholders (as bonuses) and shareholders (as profits which allow payment of dividends). And that release may never take place if, for instance, market fluctuations extinguish gains previously made.

2.27 Thus, there is currently a means of mitigating market volatility for with-profits business, and changing the basis of life assurance trade profits from regulatory surplus to financial statements should not change that.

2.28 However, it is expected that the concept of the UDS will not form part of IFRS 4 Phase II. What the alternative treatment might be is undecided, but it is understood that surplus whose ultimate destination is unknown (policyholders, shareholders or extinction) may be treated as a liability to policyholders, and withheld from profits, or “bifurcated”, with part treated as policyholder liabilities and part as shareholder profit. The basis of any potential bifurcation is unclear.

Comments would be welcome on:

The extent to which the FFA/UDS mitigates volatility for with-profits business.

How this might change under IFRS 4 Phase II?

Volatility – Linked Business

2.29 Life companies generally take their reward for carrying on linked business by way of a fee charged to the policyholder. The fee is normally a percentage of the market value of the funds under management. The level of fee income is therefore dependent on market fluctuations. There does not seem to be any reason why introducing an accounts based model for tax purposes will exacerbate the volatility which already exists.

Comments would be welcome on whether there is any justification for mitigating volatility in fee income for linked business following the introduction of an accounts based model for tax purposes.

Volatility – Business with Fixed Liabilities

2.30 A life company’s liabilities to policyholders are fixed in cases where policyholder benefits are specifically determined in the policy document or otherwise guaranteed. Examples include non-profit business and annuities in payment. The company (and its shareholders) benefit from investment return over and above what is necessary to meet the fixed policyholder entitlement. The company profit will therefore clearly be subject to volatility in market performance.

2.31 Under the current regulatory regime the “recognitions basis” described at paragraph 2.25 is not restricted to with-profit funds, although for tax purposes it is only effective for non-profit funds within a company which also has a with-profits fund.

2.32 As noted above, it has been assumed that the FFA/UDS mechanisms can only be used to mitigate volatility attributable to business within a with-profits fund. If this is right, then companies currently operating a tax effective recognitions basis in respect of business not in a with-profits fund could expect to experience greater volatility for tax under an accounts based regime.

Are there any reasons why the inherent profit volatility of business with fixed liabilities in a non-profit fund should differ from similar business in a with-profits company?

Volatility – General

2.33 Profit volatility is likely to arise where changes in asset values are not matched by changes in liabilities. The current methodology for calculating regulatory reserves includes a prudential margin, reflecting the traditional approach to liability valuation contained in existing rules. The Government understands that this margin can legitimately be determined by reference to a range of actuarial assumptions, and that this gives some scope for flexing reserving levels, and

thus mitigating volatility. It is understood that under Solvency II and probably also under IFRS 4 Phase II, liabilities will need to be current best estimates and will not contain this prudential margin, so scope for managing volatility may be reduced.

2.34 Volatility may also arise in respect of assets backing protection business or where investment returns are not matched to the discount rate used. For example, annuities in payment may be backed by corporate bonds, but without an appropriate discount rate the business will not be matched. The Government is working with industry to ensure the right solution for the relevant discount rate in relation to this particular problem under Solvency II. However, it is understood that these issues arise to the same extent in financial statement treatments, particularly under the IFRS 4 Phase II proposals.

2.35 Representations have been received to the effect that increased volatility may mean that current rules for the usage of tax losses, which are applicable to companies generally, should be amended for life companies. The suggestion is that full relief for a loss arising during the course of a long-term contract, which will over its lifetime be profitable, may not be achieved. This would be because any loss might not be set off in full, or might be set off only in a later period against other profits.

2.36 Further comment and discussion is invited on:

How, and to what extent, tax volatility might increase under an accounts based tax regime.

What the impact of any such increased volatility might be.

What measures might be taken to mitigate any adverse impact.

What are the factors that make this a particular issue for this industry, given that profits in other sectors, particularly banking, are susceptible to market volatility.

Availability of Profits

2.37 It has been suggested that it is inappropriate to tax profits at a point when, although recognised for accounting purposes, there may be restrictions on the ability of the company to distribute them to shareholders.

2.38 As noted in paragraph 2.21 above, the Government's initial assumption is that the profit reported in financial statements represents a proper view of a company's results, suitable for tax purposes subject to certain tax-specific adjustments. Those adjustments, applicable to the generality of trading companies, do not include any reference to whether profits are, or can be, actually distributed to shareholders as dividends or otherwise. It is not obvious that there is a tax link between the making of profits and the ability of shareholders to access shareholder funds. No tax allowance is made for situations where, for example, a company makes profits but has insufficient cash available to pay dividends, or where a profit is made, but there are insufficient shareholder funds to permit a distribution. Nor is any allowance made where, for instance, a company simply decides to use, rather than distribute, profits.

2.39 Equally, there is no suggestion that shareholder funds should become taxable merely because they have become distributable, for instance on a reduction in a share premium account. Indeed, HMRC is aware of instances in which arrangements have been entered into to enable companies to recognise amounts as profit for accounting purposes so that dividends can be paid, without, it is argued, any tax liability arising on those profits.

Further comment is welcomed on any general principle considered to link taxation of profits to their availability to shareholders.

2.40 The Government is at present doubtful of a general link between taxation and availability of profits to shareholders. At the same time, however, it is clear that a life company may find itself in circumstances which other companies do not. One unique feature of life companies is that they have long term liabilities to policyholders, which they must at all times be in a position to meet. They are subject to a regulatory regime whose fundamental purpose is to ensure that this is the case – that is, that they remain solvent. Thus they are supervised by the FSA, and in the case of some activities, notably transfers of business and reattributions of estates, by the courts. The supervisory regime may bind life companies to certain arrangements, tailored to specific circumstances and intended to safeguard the interests of policyholders, or particular groups of policyholders. These arrangements may include, for example, court orders requiring the retention of certain assets or controlling the withdrawal of profits by shareholders.

2.41 The Government sees therefore that there is a wide spectrum of circumstances in which profits may not be “available” to shareholders, ranging from a prohibition imposed by a court to a decision not to pay dividends. Further, it is acknowledged that it might be possible to take a different view of scenarios across that spectrum.

2.42 In order to give proper consideration to representations made, views are therefore invited on:

What circumstances would be considered to render profits “unavailable” to shareholders?

In which of those circumstances is it thought that taxation of profits should be deferred? And why?

2.43 A particular area on which representations have been received is the tax treatment of the FFA/UDS, described in paragraph 2.26 above. The point made is that this balance represents surplus which has arisen, but which has yet to be allocated between policyholders and shareholders. It is not therefore possible to say with certainty to what extent it will ultimately form part of shareholder profits. It is suggested that, until an allocation is made to shareholders, the FFA/UDS should therefore not be subject to tax.

2.44 It is understood that the FFA/UDS represents, in theoretical terms, the balance of the value of assets in a fund after taking account of amounts already allocated to policyholders, or expected to be so allocated (and therefore included in liabilities), and amounts allocated to shareholders. It is also believed that the FFA/UDS is intended to apply to with-profits business only. However, the Government needs a clearer picture of how this mechanism operates in practice. Comment is therefore welcome on the following questions:

To what extent is it possible for the FFA/UDS to contain value not wholly attributable to with-profits business?

What mechanisms are used to restrict the use of the FFA/UDS to with-profits business?

How do those mechanisms work where a with-profits fund includes non-participating business?

What degree of discretion does a company have in determining the amounts and timing of allocations to the FFA/UDS, and in releasing them to profit, and what constraints exist?

What approach do companies take in deciding what amounts should be added to, or withdrawn from, the FFA/UDS in any period, and how is that process evidenced and documented?

How will the profit figure be used?

Permanent Health insurance

2.45 PHI was excluded from the amalgamation of the gross-roll up categories of business in 2007 in the light of concerns raised by industry.

Under a regime based on financial statements, is it appropriate to reconsider whether PHI profits should continue to be computed separately?

Shareholder Assets

2.46 Currently income and gains arising on shareholder assets are taxed on a standalone basis. In financial statements, however, there is no clear distinction between shareholder assets and other assets of the company.

2.47 All non-structural investment assets held by an insurance company are at risk in its insurance business and, in the case of general insurance, income arising on these assets enters into the computation of Case I profits.

Is there a principled basis for continuing to distinguish life insurance companies from general insurance companies in taxing the income arising on non-structural investments representing shareholder capital?

Interaction of Life Assurance Trade Profits and I-E

2.48 Where a life company's business is substantially all within the gross roll up category, or is all reinsurance business, it is taxed on its trade profits. Other life companies are taxed under the I-E system. For these companies, trade profits are not themselves charged to tax, but they are used in determining the tax payable.

2.49 Moving from the regulatory return to an accounts basis requires amendment of the legislation which determines, for I-E companies, the quantum of I-E profits and the rates of tax applied to those profits.

Quantum of I-E Profits

2.50 I-E collects tax on both the shareholder profits and policyholder profits. To ensure that the amount taxed under I-E is always at least equivalent to the company's life assurance trade profits (adjusted to remove exempt distributions) that figure is compared with the total I-E profits, that is BLAGAB income and chargeable gains net of allowable expenses, plus GRB profits. If the former exceeds the latter additional BLAGAB income equal to the excess is brought into charge. An amount equal to the excess is added to expenses carried forward.

2.51 Where the excess is attributable to the reduction of GRB profits for the period by GRB losses carried forward this can have the unforeseen consequence of converting GRB losses into excess expenses.

2.52 It is understood that some life companies recognise significant amounts of accumulated tax assets on their balance sheets or in calculating embedded values. The recognition of such tax assets is permissible under accounting rules, provided that the company can reasonably expect the assets to be recoverable. The conversion of GRB losses into excess expenses in a company which already has significant expenses carried forward may cause or exacerbate the writing off of any tax assets which represent the value of those expenses.

In moving to an accounts based measure should the opportunity be taken to mitigate the commercial impact of the build up of excess expenses? How might this be done?

Allocation of Amounts to be taxed at Policyholder and Shareholder Rates

2.53 Adjusted life assurance trade profits are taxed at the corporation tax rate with the balance, i.e. the policyholders' share of I-E profits, taxed at the basic rate of income tax. Where there are no overall life assurance trade profits, GRB trade profits will form part of the policyholders' share of profit to be taxed at the lower rate. As a consequence of the move away from the regulatory return, the mechanism which determines the policyholders' share of profits may need to be modified. It may not be appropriate to continue to charge GRB profits at the policyholder rate of tax when they accrue solely for the benefit of shareholders.

What basis should be used to determine the policyholders' share of I-E profits?

Mutual Companies

2.54 This Chapter is concerned with trade profits. Insurance undertaken on a mutual basis is a trade, but the surplus from mutual business is not a profit capable of being charged to tax. Mutual companies do not have shareholders, and are effectively owned by the policyholders by virtue of their membership interests. The functions for which the trading profit result is used in a proprietary company taxed under I-E are generally not relevant to mutuals. Thus there is no minimum profits test to ensure that the amount taxable under I-E does not fall below that which would have been assessed on a trading profits basis. And the trading profit is not used to establish the amounts to be taxed at policyholder and shareholder rates - all profits from mutual business are taxed at the policyholder rate.

2.55 The concept of trade profits is therefore of less relevance to mutual companies than to proprietary companies. However, mutual companies do need to compute profits arising on their gross roll up business, and for this the principles applying to trade profits are used.

Views are welcome on:

How the issues discussed in this chapter (and elsewhere in this consultation document) apply differently to mutual companies?

What particular measures may be needed to take account of those differences?

Friendly Societies

2.56 The Government understands that some Friendly Societies are likely to fall outside the scope of Solvency II, and assume that these will be those classified as "non directive" societies.

Views are welcome on:

To what extent is the Friendly Society sector expected to fall outside Solvency II?

What arrangements will be made for regulatory supervision of Friendly Societies outside Solvency II? To what extent are those arrangements expected to mirror the Solvency II rules?

What are the implications of the issues discussed in this chapter (and elsewhere in this consultation document) for Friendly Societies?

What particular measures may be needed to take account of those implications?

2.57 "Tax exempt other business" carried on by a Friendly Society, and subsequently transferred into a life company, is treated as a separate business in the life company, and retains its tax-exempt status. The same applies to tax exempt business carried on by a Friendly Society which converts to an insurance company.

Are there any particular issues, not covered in paragraph 2.58 onwards, arising in respect of apportionments to tax exempt business?

Apportionments

2.58 As is the case now, it will be necessary to have rules which determine income and chargeable gains referable to BLAGAB, and how much of the accounts income and gains is to be included in the computation of trade profits for other categories of business.

Income and Chargeable Gains referable to BLAGAB

2.59 The current allocation basis is a modified mean liability basis. The modification consists of the allocation of the free asset amount, that is the difference between the assets and liabilities of the long term insurance fund (LTIF), between categories of business on the basis of total liabilities when all the business of the company is non-participating and on the basis of with-profit liabilities when there is participating business.

2.60 At present there is a distinction in the regulatory return between income arising on the assets of the LTIF, which enters into Form 40, and income arising on other assets of the company, which enters into Form 16.

Will such a distinction continue for regulatory and/or accounting purposes?

Is such a distinction made and apparent in the financial statements? If not, what should be the starting point for ascertainment of chargeable gains and income referable to BLAGAB?

Are there any other prospective Solvency II or accounting changes which suggest modification of the current apportionment rule would be appropriate? For example, if realistic liabilities reflect terminal bonuses would this allow a simple mean liability basis to be used?

Income and Chargeable Gains referable to non-BLAGAB Business

2.61 There are a number of rules which apply to determine how much of the income and gains brought into account in the regulatory return is referable to categories of business other than BLAGAB. The rules are applied separately to each with-profits fund and the balance of the LTIF. The rule applied to the latter differs from the rules applied to the former. Within the accounts there is no segregation of income between funds.

How should the accounts income be allocated between categories of business?

2.62 Past experience shows that the different rules for allocation of income to BLAGAB and the other categories of business lead to an apparent under- or over-allocation of income. This could be avoided by a single rule used for all purposes.

Is it possible to devise such a rule and what would it consist of?

Direct Allocation of Income

2.63 Apportionment is only necessary when income and gains arising on an asset cannot be allocated directly to a category of business. Currently linked asset income and gains are allocated directly. As linkage is both a regulatory and accounting concept, no change is anticipated.

Are there any opportunities to extend direct allocation?

Where a company has adopted IFRS or FRS 26 and has classified certain contracts as investment contracts, should the accounts income and gains be allocated directly to investment contract business?

Would the accounting records also allow direct allocation of income and chargeable gains to BLAGAB?

3

General insurance issues

General

3.1 Introduction of the Solvency II Directive is expected to directly impact the taxation of General Insurers in two ways:

- a) The removal of the regulatory requirement for Claims Equalisation Reserves (CERs) will result in related tax adjustments no longer being available.
- b) If the new Solvency II methodology for calculating insurance technical reserves is followed for financial statements there will be a one-off transitional impact, and an ongoing change to current methods and levels of technical reserving.

Claims Equalisation Reserves

3.2 Claims Equalisation Reserves (CERs) are a regulatory requirement relating specifically to certain lines of general insurance business that are recognised as being susceptible to volatile results, particularly lines of business where there is exposure to singular events, such as major climate catastrophes or terrorism. CERs enable a general insurer to build up reserves in periods when low claims are experienced. These reserves can then be released to smooth out losses in the periods when large claims arise.

3.3 Tax adjustments for regulatory CER movements were brought into effect during the 1990s and give some degree of smoothing specific to the taxable profits arising from the most volatile lines of business. In addition, Finance Act 2009 introduced the concept of CERs for Lloyd's members as a tax only adjustment to bring them in line with other general insurers.

3.4 Section 444BA ICTA 1988 (and SI 2009/2039 for Lloyd's) compute tax adjustments by reference to the CERs established for regulatory purposes. If regulatory CERs are no longer required under Solvency II, then without specific further measures no further tax adjustments would arise, and any reserves established for regulatory purposes would be released and charged to tax.

3.5 Representations have been received to the effect that it might be appropriate to continue to permit an element of smoothing of the tax results by way of an adjustment to profits, which would echo the effect of the current mechanism.

Views are welcome on the following questions;

How effective are the current CER rules in helping to smooth the profits of the most volatile lines of business?

Given that under Solvency II CERs are no longer expected to be required, how will insurers react commercially? Are there alternative measures which insurers could, or will have to, take to spread the effect of major claims "spikes"?

What would be the impact if there were no replacement mechanism?

If a replacement system were to be implemented, what should it look like?

What administrative and compliance costs would be involved for business in administering any stand-alone replacement system?

If no replacement system were to be implemented, on what basis should any built up reserves be released to tax?

Calculation of insurance technical reserves

3.6 General insurers' technical reserves calculated under Solvency II are generally anticipated to be lower than the current levels of reserves held in accounts. The effect of Solvency II is expected to be broadly to increase the level and quality of capital held, while the liabilities recognised will no longer include an element of prudence, and so will fall.

3.7 General insurance companies, unlike life companies, are currently taxed on the profits shown in their statutory accounts, rather than by reference to regulatory requirements. Thus Solvency II in itself will not have an impact on the liabilities used for tax purposes.

3.8 However, it is anticipated that companies might choose for a number of reasons to base the technical provisions used in their financial statements on those calculated for Solvency II purposes. There would clearly be an efficiency incentive to avoid two sets of calculations, for example. In this situation there would be a change to the accounting technical provisions, and a tax impact. Additionally, IFRS 4 Phase II (referred to in Chapter 2) may ultimately also lead to a convergence (probably downwards) of accounting technical provisions with Solvency II liabilities.

3.9 Any such change in the methodology for calculating accounting technical provisions is therefore likely to mean:

- a) An initial one-off reduction in levels of technical reserves, which would have an impact for tax purposes in the year of change without further measures.
- b) Lower levels of technical reserves on an on-going basis.

Views are welcome on the following questions:

What is the expected impact on tax of changes to technical reserving under Solvency II?

If technical reserves in the financial statements follow Solvency II, how should any step change on transition be dealt with for tax?

Bearing in mind that it is the change in reserves rather than their overall level which impacts on profits in any period, how much would ongoing reduced levels of technical reserves affect the results of general insurers and how could any effects be mitigated?

4

Potential wider reform of the I-E Regime

- 4.1** The I-E system is now very unusual in international terms – the number of countries which operate an I-E system has fallen in number in recent years.
- 4.2** The value of the system, conceptually, is that it provides a mechanism for collecting tax on both company profits and those accruing to certain policyholders. This has benefits for the Exchequer. It collects tax at a company level on policyholders' accrued profits without the need for annual assessment on individual policyholders themselves.
- 4.3** The resulting system is, however, complex. Much work has been done to address this over the past few years. The industry and HMRC have worked closely together on simplifying the legislation, which has resulted in a significant pruning and streamlining of the rules. Some of the more intractable difficulties remain though. It may be that any system which attempts to integrate two different functions (the taxation of company profits, and accrued policyholder benefits) is inevitably going to have that element of complexity.
- 4.4** Despite the work that has been successfully undertaken, structural problems with the system remain. In broad terms the I-E system sets expenses ("E") against income ("I"). These expenses are the expenses of operating the business, and issuing policies, and the income is largely the income from the investment of the funds attached to those policies.
- 4.5** Clearly, for companies within the I-E system the greatest tax efficiency is obtained when all expenses are fully relieved against income. That is not always achieved. The vagaries of investment return, and of expenditure, can produce the temporary situation where E exceeds I. But the issue can also arise structurally. Certain types of life insurance business produce high levels of expenditure (protection only insurance policies for instance) combined with relatively low levels of income. Other types of business produce more income than expenditure. The picture is complicated by the fact that different types of business can produce different results over the life of a policy, typically generating net expenditure in the early years of a policy, and net income in the later.
- 4.6** Depending on the mix of business written, some companies can find themselves inevitably producing excess E. This can lead to such companies facing a tax incentive to write certain types of business, and of course a disincentive to write others. Conversely companies with business producing excess I have a tax incentive to write business producing excess E. It has been suggested that the tax distortions inherent in the system can lead to market distortion, with the tax incentive representing a barrier to entry for certain types of business, such as protection business, although it is not clear to what extent this is an issue in practice.
- 4.7** This issue is not new. What is sometimes termed the "protection business" distortion is something that has long been recognised as a feature of the system. For that reason, companies which only write protection business are not taxed under I-E. And there is a provision within the legislation, introduced in 2007, which can increase the charge to tax if the amount chargeable in respect of a particular year under I-E is less than would have been charged if the company were taxed on its trading profits in the usual way.
- 4.8** The likelihood of exposure to a structural excess E position increases when sales of investment products fall, and a number of companies have indicated that they are currently

experiencing such a scenario. Additionally the 2007 changes provide that any charge to tax is balanced by additional E which can then be carried forward, potentially exacerbating the excess of E over I.

4.9 Solvency II does not require a move away from I – E. It may, though, be possible to use a more radical approach to address some of the more problematic areas of fitting necessary changes arising from Solvency II with the current I-E system, and at the same time to address some of the problems raised by the structural excess E problems. For instance, an approach which calculated separately the accrued benefit to policyholders each year might avoid the need to apportion income and gains. That apportionment has proved a difficult and controversial feature of I-E, and Solvency II is unlikely to resolve any of those inherent difficulties. A number of apportionment issues are discussed above at paragraph 2.58 onwards.

4.10 Such a new approach would not be an easy option. Although some of the more difficult areas in translating I-E into a Solvency II environment would be avoided, there would probably be equivalent issues to overcome in considering a practical alternative. The question is whether there would be sufficient benefit in attempting to produce such an alternative, either in the context of the Solvency II exercise, or on a longer timescale?

4.11 It is recognised that the current I-E system does, on the one hand, produce significant cash flow for the Exchequer, and on the other, result in tax values being recognised both in the valuation of company's liabilities and more directly in their balance sheets. Those are both matters that need to be borne carefully in mind. Nonetheless there does appear to be scope for discussing with industry the possibility of an alternative to, or modifications to, I-E.

4.12 The Government would welcome further discussion of the issue with the industry.

5

Summary of questions

Chapter 2

- 2.9 Comment is welcome on the starting point for the determination of life assurance trade profits as set out in paragraph 2.8, including whether there might be circumstances where a different figure from the accounts would be more appropriate (for example to take account of exceptional items).
- 2.10 Comment is welcome on the implications for life companies of the ASB's proposals described in paragraph 2.10, and in particular on the impact of the ASB's proposed timetable and on the question as to whether there any categories of life company which would not fall to be classified as 'publicly accountable'.
- 2.11 Comment is welcome on the potential impact on the accounts of likely changes in technical provisions for solvency purposes. In particular, for companies applying UK GAAP or current IFRS, do you consider that technical provisions in financial statements will need to change to reflect changes in mathematical reserves for Solvency purposes, or could this remain a matter of choice?
- 2.15 Comment is welcome on whether special transitional measures would be appropriate for the potential subsequent changes in basis outlined in paragraph 2.15(b), or whether the normal rules for dealing with changes in accounting policies would be sufficient to deal with such potential changes.
- Comment is welcome on the potential impact on life companies of more than one major change in the basis of life assurance trade profits in quick succession, and on ways in which any adverse impact might be mitigated.
- 2.18 Comment is welcome on the need, and justification, for introducing specific transitional measures to deal with step changes in the values of assets and liabilities, including comment on what specific adjustments might be appropriate.
- 2.20 In what instances might it be appropriate to reconsider the application of general tax rules to life companies?
- How might the application of such rules be changed, and why?
- 2.28 To what extent does the FFA/UDS mitigate volatility for with-profits business?
- How this might change under IFRS 4 Phase II?
- 2.29 Comments would be welcome on whether there is any justification for mitigating volatility in fee income for linked business following the introduction of an accounts based model for tax purposes.
- 2.32 Are there any reasons why the inherent profit volatility of business with fixed liabilities in a non-profit fund should differ from similar business in a with-profits company?
- 2.36 How, and to what extent, might tax volatility increase under an accounts based tax regime?

What might the impact of any such increased volatility be?

What measures might be taken to mitigate any adverse impact?

What are the factors that make volatility a particular issue for this industry, given that profits in other sectors, particularly banking, are susceptible to market volatility?

2.39 Comment is welcomed on any general principle considered to link taxation of profits to their availability to shareholders.

2.42 What circumstances would be considered to render profits “unavailable” to shareholders?

In which of those circumstances is it thought that taxation of profits should be deferred? And why?

2.44 To what extent is it possible for the FFA/UDS to contain value not wholly attributable to with-profits business?

What mechanisms are used to restrict the use of the FFA/UDS to with-profits business?

How do those mechanisms work where a with-profits fund includes non-participating business?

What degree of discretion does a company have in determining the amounts and timing of allocations to the FFA/UDS, and in releasing them to profit, and what constraints exist?

What approach do companies take in deciding what amounts should be added to, or withdrawn from, the FFA/UDS in any period, and how is that process evidenced and documented?

2.45 Under a regime based on financial statements, is it appropriate to consider whether PHI profits should continue to be computed separately?

2.47 Is there a principled basis for continuing to distinguish life insurance companies from general insurance companies in taxing the income arising on non-structural investments representing shareholder capital?

2.52 In moving to an accounts based measure should the opportunity be taken to mitigate the commercial impact of the build up of excess expenses? How might this be done?

2.53 What basis should be used to determine the policyholders’ share of I-E profits?

2.55 How do the issues discussed in this chapter (and elsewhere in this consultation document) apply differently to mutual companies?

What particular measures may be needed to take account of those differences?

2.56 To what extent is the Friendly Society sector expected to fall outside Solvency II?

What arrangements will be made for regulatory supervision of Friendly Societies outside Solvency II? To what extent are those arrangements expected to mirror the Solvency II rules?

What are the implications of the issues discussed in this chapter (and elsewhere in this consultation document) for Friendly Societies?

What particular measures may be needed to take account of those implications?

2.57 Are there any particular issues, not covered in paragraph 2.58 onwards, arising in respect of apportionments to tax exempt business?

2.60 Will a distinction between LTIF and other assets continue for regulatory and/or accounting purposes?

Is such a distinction made and apparent in the financial statements? If not, what should be the starting point for ascertainment of chargeable gains and income referable to BLAGAB?

Are there any other prospective Solvency II or accounting changes which suggest modification of the current apportionment rule would be appropriate? For example, if realistic liabilities reflect terminal bonuses would this allow a simple mean liability basis to be used?

2.61 How should the accounts income be allocated between categories of business?

2.62 Is it possible to devise a single apportionment rule for all purposes, and what would it consist of?

2.63 Are there any opportunities to extend direct allocation?

Where a company has adopted IFRS or FRS 26 and has classified certain contracts as investment contracts, should the accounts income and gains be allocated directly to investment contract business?

Would the accounting records also allow direct allocation of income and chargeable gains to BLAGAB?

Chapter 3

3.5 How effective are the current CER rules in helping to smooth the profits of the most volatile lines of business?

Given that under Solvency II CERs are no longer expected to be required, how will insurers react commercially? Are there alternative measures which insurers could, or will have to, take to spread the effect of major claims "spikes"?

What would be the impact if there were no replacement mechanism?

If a replacement system were to be implemented, what should it look like?

What administrative and compliance costs would be involved for business in administering any stand-alone replacement system?

If no replacement system were to be implemented, on what basis should any built up reserves be released to tax?

3.9 What is the expected impact on tax of changes to general insurers' technical reserving under Solvency II?

If technical reserves in the financial statements follow Solvency II, how, for general insurers, should any step change on transition be dealt with for tax?

Bearing in mind that it is the change in reserves rather than their overall level which impacts on profits in any period, how much would ongoing reduced levels of technical reserves affect the results of general insurers and how could any effects be mitigated?

A

Consultation code of practice

About the consultation process

This consultation is being conducted in accordance with the Government's Code of Practice on Consultation. If you wish to access the full version of the Code, you can obtain it online at:

<http://www.berr.gov.uk/files/file47158.pdf>

The consultation criteria

1. When to consult - Formal consultation should take place at a stage when there is scope to influence the policy outcome.
2. Duration of consultation exercises - Consultations should normally last for at least 12 weeks with consideration given to longer timescales where feasible and sensible.
3. Clarity of scope and impact - Consultation documents should be clear about the consultation process, what is being proposed, the scope to influence and the expected costs and benefits of the proposals.
4. Accessibility of consultation exercise - Consultation exercises should be designed to be accessible to, and clearly targeted at, those people the exercise is intended to reach.
5. The burden of consultation - Keeping the burden of consultation to a minimum is essential if consultations are to be effective and if consultees' buy-in to the process is to be obtained.
6. Responsiveness of consultation exercises - Consultation responses should be analysed carefully and clear feedback should be provided to participants following the consultation.
7. Capacity to consult - Officials running consultations should seek guidance in how to run an effective consultation exercise and share what they have learned from the experience.

If you feel that this consultation does not satisfy these criteria, or if you have any complaints or comments about the process, please contact:

Richard Bowyer, Better Regulation Unit
020 7147 0062 or richard.bowyer@hmrc.gsi.gov.uk

B

Impact Assessment

Summary: Intervention & Options

Department /Agency: HM Treasury/HMRC	Title: Impact Assessment: Solvency II and the Taxation of Insurance Companies	
Stage: Consultation	Version: 1.0	Date: 1 March 2010
Related Publications: Consultation Document: Solvency II and the Taxation of Insurance Companies		

Available to view or download at:

<http://www.hmrc.gov.uk/better-regulation/ia.htm>

Contact for enquiries: Andy Stewardson

Telephone: 0207 147 2600

What is the problem under consideration? Why is government intervention necessary?

From October 2012 UK insurance companies will be regulated by reference to a new EU Directive - "Solvency II". Taxation of life companies is currently based on the existing regulatory reporting arrangements. When those arrangements are superseded, a new basis for computing life company profits will inevitably be required. Solvency II will also have tax implications for general insurance companies, which have to be addressed.

In conjunction with these necessary changes, the government would like to canvas views as to the desirability of wider changes to life company taxation.

What are the policy objectives and the intended effects?

This consultation is aimed at ensuring that government is in a position to respond appropriately to the tax implications of Solvency II, and that the insurance industry continues to be taxed effectively and fairly. It will identify issues arising for life and general insurers, and options for resolving them. In particular it will explore issues associated with the Government's proposed adoption of statutory accounts as the basis for life company taxation, and changes in reserving for general insurers.

5.1 What policy options have been considered? Please justify any preferred option.

Life Companies - Option 1: Adopt a statutory accounts basis for life company tax computations with only necessary consequential amendments to the life tax code. Option 2: Adopt Option 1 while also incorporating further industry specific adjustments to accounting profits.

GI Companies - Option 3: Do nothing. Option 4: Introduce "tax only" claims equalisation reserves. Option 5: Introduce measures to modify the effects of changes in reserving, either alongside or instead of Option 4.

When will the policy be reviewed to establish the actual costs and benefits and the achievement of the desired effects? Post implementation review will take place around three years after after implementation. Emerging issues will be kept under review in conjunction with industry.

Ministerial Sign-off For consultation stage Impact Assessments:

I have read the Impact Assessment and I am satisfied that, given the available evidence, it represents a reasonable view of the likely costs, benefits and impact of the leading options.

Signed by the responsible Minister:

Date: 10 March 2010



Summary: Analysis & Evidence

Policy Option: 1

Description: Life Companies - Adopt a statutory accounts basis for tax computations and make necessary consequential changes to the life tax code.

COSTS	ANNUAL COSTS		Description and scale of key monetised costs by 'main affected groups' There would be no change to the statutory requirement for companies to produce financial statements. Nor would there be a change in the requirement to produce corporation tax computations. Costs should therefore be nil or negligible.	
	One-off (Transition)	Yrs		
	£ Negligible			
	Average Annual Cost (excluding one-off)			
	£ Negligible		Total Cost (PV)	£ Negligible
Other key non-monetised costs by 'main affected groups' New rules would entail a familiarisation and training cost to taxpayers and HMRC.				

BENEFITS	ANNUAL BENEFITS		Description and scale of key monetised benefits by 'main affected groups' None identified at this stage. Refer to paragraphs 15 - 16 of the Evidence Base.	
	One-off	Yrs		
	£ N/A			
	Average Annual Benefit (excluding one-off)			
	£ N/A		Total Benefit (PV)	£ N/A
Other key non-monetised benefits by 'main affected groups' Post-transition, there may be a reduction in the complexity of the life tax code for both taxpayers and HMRC.				

Key Assumptions/Sensitivities/Risks

Cost/benefit effects will be subject to the actual nature of any new rules introduced following consultation.

Price Base Year 2010	Time Period Years TBC	Net Benefit Range (NPV) £	NET BENEFIT (NPV Best estimate) £ TBC
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What is the geographic coverage of the policy/option?	United Kingdom			
On what date will the policy be implemented?	1/1/2012			
Which organisation(s) will enforce the policy?	HMRC			
What is the total annual cost of enforcement for these organisations?	£ Nil incremental			
Does enforcement comply with Hampton principles?	N/A			
Will implementation go beyond minimum EU requirements?	No			
What is the value of the proposed offsetting measure per year?	£ Not applicable			
What is the value of changes in greenhouse gas emissions?	£ Not applicable			
Will the proposal have a significant impact on competition?	No			
Annual cost (£-£) per organisation (excluding one-off)	Micro N/A	Small N/A	Medium TBC	Large TBC
Are any of these organisations exempt?	No	No	N/A	N/A

Impact on Admin Burdens Baseline (2005 Prices)			(Increase - Decrease)
Increase of	£ Nil	Decrease of	£ Nil
Net Impact			£ Nil

Key: Annual costs and benefits: (Net) Present

Summary: Analysis & Evidence

Policy Option: 2	Description: Life Companies - Adopt Option 1 with appropriate sector-specific adjustments to accounting profits.
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COSTS	ANNUAL COSTS	Description and scale of key monetised costs by 'main affected groups' There would be no change to the statutory requirement for companies to produce financial statements. Nor would there be a change in the requirement to produce corporation tax computations. Costs should therefore be negligible.			
	One-off (Transition) Yrs				
	£ Negligible				
	Average Annual Cost (excluding one-off)				
	£ Negligible	Total Cost (PV)	£ Negligible		
Other key non-monetised costs by 'main affected groups' New rules would entail a familiarisation and training cost to taxpayers and HMRC greater than for Option 1.					

BENEFITS	ANNUAL BENEFITS	Description and scale of key monetised benefits by 'main affected groups' None identified at this stage. Refer to paragraphs 15 - 16 of the Evidence Base.			
	One-off Yrs				
	£ N/A				
	Average Annual Benefit (excluding one-off)				
	£ N/A	Total Benefit (PV)	£ N/A		
Other key non-monetised benefits by 'main affected groups' There may be scope for simplification of the existing regime, depending on the outcome of consultation.					

Key Assumptions/Sensitivities/Risks	Cost/benefit effects will be subject to the actual nature of any new rules introduced following consultation.
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Price Base Year 2010	Time Period Years TBC	Net Benefit Range (NPV) £	NET BENEFIT (NPV Best estimate) £ TBC
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What is the geographic coverage of the policy/option?	United Kingdom			
On what date will the policy be implemented?	1/1/2012			
Which organisation(s) will enforce the policy?	HMRC			
What is the total annual cost of enforcement for these organisations?	£ Nil incremental			
Does enforcement comply with Hampton principles?	N/A			
Will implementation go beyond minimum EU requirements?	No			
What is the value of the proposed offsetting measure per year?	£ Not applicable			
What is the value of changes in greenhouse gas emissions?	£ Not applicable			
Will the proposal have a significant impact on competition?	No			
Annual cost (£-£) per organisation (excluding one-off)	Micro N/A	Small N/A	Medium TBC	Large TBC
Are any of these organisations exempt?	No	No	N/A	N/A

Impact on Admin Burdens Baseline (2005 Prices)			(Increase - Decrease)
Increase of	£ Nil	Decrease of	£ Nil
		Net Impact	£ Nil

Key: Annual costs and benefits: Constant Prices (Net) Present Value

Summary: Analysis & Evidence

Policy Option: 4	Description: General Insurance Companies - Introduce "tax only" claims equalisation reserves.
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COSTS	ANNUAL COSTS	Description and scale of key monetised costs by 'main affected groups' This option would enable companies to continue the effect, for tax purposes only, of making reserves previously permitted by regulatory rules. The additional new cost impact should be nil or negligible.		
	One-off (Transition) Yrs			
	£ Negligible			
	Average Annual Cost (excluding one-off)			
	£ Negligible	Total Cost (PV)	£ Negligible	
Other key non-monetised costs by 'main affected groups' None identified.				

BENEFITS	ANNUAL BENEFITS	Description and scale of key monetised benefits by 'main affected groups' No administrative or compliance benefits identified at this stage, but the industry has proposed a measure of this kind, so this option is likely to be welcomed.		
	One-off Yrs			
	£ N/A			
	Average Annual Benefit (excluding one-off)			
	£ N/A	Total Benefit (PV)	£ N/A	
Other key non-monetised benefits by 'main affected groups' None identified, but the option is likely to be welcomed by industry.				

Key Assumptions/Sensitivities/Risks
Cost/benefit effects will be subject to the actual nature of any new rules introduced following consultation.

Price Base Year 2010	Time Period Years TBC	Net Benefit Range (NPV) £	NET BENEFIT (NPV Best estimate) £ TBC
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What is the geographic coverage of the policy/option?	United Kingdom				
On what date will the policy be implemented?	1/1/2012				
Which organisation(s) will enforce the policy?	HMRC				
What is the total annual cost of enforcement for these organisations?	£ Nil incremental				
Does enforcement comply with Hampton principles?	N/A				
Will implementation go beyond minimum EU requirements?	No				
What is the value of the proposed offsetting measure per year?	£ Not applicable				
What is the value of changes in greenhouse gas emissions?	£ Not applicable				
Will the proposal have a significant impact on competition?	No				
Annual cost (£-£) per organisation (excluding one-off)	<table style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 25%; text-align: center;">Micro N/A</td> <td style="width: 25%; text-align: center;">Small N/A</td> <td style="width: 25%; text-align: center;">Medium TBC</td> <td style="width: 25%; text-align: center;">Large TBC</td> </tr> </table>	Micro N/A	Small N/A	Medium TBC	Large TBC
Micro N/A	Small N/A	Medium TBC	Large TBC		
Are any of these organisations exempt?	<table style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 25%; text-align: center;">No</td> <td style="width: 25%; text-align: center;">No</td> <td style="width: 25%; text-align: center;">N/A</td> <td style="width: 25%; text-align: center;">N/A</td> </tr> </table>	No	No	N/A	N/A
No	No	N/A	N/A		

Impact on Admin Burdens Baseline (2005 Prices)		(Increase - Decrease)
Increase of £ Nil	Decrease of £ Nil	Net Impact £ Nil

Key: Annual costs and benefits: Constant Prices (Net) Present Value

Summary: Analysis & Evidence

Policy Option: 5	Description: General Insurance Companies - Introduce measures to modify the effects of changes in reserving, alongside or instead of Option 3.
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COSTS	ANNUAL COSTS	Description and scale of key monetised costs by 'main affected groups' This option would entail changes to the corporation tax computation, which could marginally increase costs. However the overall number of companies affected is likely to be less than 100 so the overall admin change could be negligible.				
	<table border="1" style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 60%; padding: 2px;">One-off (Transition)</td> <td style="width: 40%; text-align: center; padding: 2px;">Yrs</td> </tr> <tr> <td style="padding: 2px;">£ Negligible</td> <td></td> </tr> </table>		One-off (Transition)	Yrs	£ Negligible	
	One-off (Transition)		Yrs			
	£ Negligible					
<table border="1" style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 60%; padding: 2px;">Average Annual Cost (excluding one-off)</td> <td></td> </tr> <tr> <td style="padding: 2px;">£ Negligible</td> <td></td> </tr> </table>	Average Annual Cost (excluding one-off)		£ Negligible			
Average Annual Cost (excluding one-off)						
£ Negligible						
Total Cost (PV)		£ Negligible				
Other key non-monetised costs by 'main affected groups' None identified at this stage.						

BENEFITS	ANNUAL BENEFITS	Description and scale of key monetised benefits by 'main affected groups' None identified at this stage.				
	<table border="1" style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 60%; padding: 2px;">One-off</td> <td style="width: 40%; text-align: center; padding: 2px;">Yrs</td> </tr> <tr> <td style="padding: 2px;">£ Unknown</td> <td></td> </tr> </table>		One-off	Yrs	£ Unknown	
	One-off		Yrs			
	£ Unknown					
<table border="1" style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 60%; padding: 2px;">Average Annual Benefit (excluding one-off)</td> <td></td> </tr> <tr> <td style="padding: 2px;">£ Unknown</td> <td></td> </tr> </table>	Average Annual Benefit (excluding one-off)		£ Unknown			
Average Annual Benefit (excluding one-off)						
£ Unknown						
Total Benefit (PV)		£ Unknown				
Other key non-monetised benefits by 'main affected groups' None identified at this stage.						

Key Assumptions/Sensitivities/Risks

Cost/benefit effects will be subject to the actual nature of the new rules introduced and dependant on responses from the sector to this consultation.

Price Base Year 2010	Time Period Years TBC	Net Benefit Range (NPV) £	NET BENEFIT (NPV Best estimate) £ TBC
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What is the geographic coverage of the policy/option?	United Kingdom				
On what date will the policy be implemented?	1/1/2012				
Which organisation(s) will enforce the policy?	HMRC				
What is the total annual cost of enforcement for these organisations?	£ Nil incremental				
Does enforcement comply with Hampton principles?	N/A				
Will implementation go beyond minimum EU requirements?	No				
What is the value of the proposed offsetting measure per year?	£ Not applicable				
What is the value of changes in greenhouse gas emissions?	£ Not applicable				
Will the proposal have a significant impact on competition?	No				
Annual cost (£-£) per organisation (excluding one-off)	<table border="1" style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 25%; text-align: center;">Micro N/A</td> <td style="width: 25%; text-align: center;">Small N/A</td> <td style="width: 25%; text-align: center;">Medium TBC</td> <td style="width: 25%; text-align: center;">Large TBC</td> </tr> </table>	Micro N/A	Small N/A	Medium TBC	Large TBC
Micro N/A	Small N/A	Medium TBC	Large TBC		
Are any of these organisations exempt?	<table border="1" style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 25%; text-align: center;">No</td> <td style="width: 25%; text-align: center;">No</td> <td style="width: 25%; text-align: center;">N/A</td> <td style="width: 25%; text-align: center;">N/A</td> </tr> </table>	No	No	N/A	N/A
No	No	N/A	N/A		

Impact on Admin Burdens Baseline (2005 Prices)		(Increase - Decrease)
Increase of £ Nil	Decrease of £ Nil	Net Impact £ Nil

Key: Annual costs and benefits: Constant Prices (Net) Present Value

Evidence Base (for summary sheets)

Introduction

1. The Solvency II Directive is an EU-wide capital adequacy regime for insurers that is currently scheduled to come into effect in October 2012. It aims to introduce a modernised, risk-based approach to the regulation of insurance companies whilst at the same time ensuring appropriate protection for policyholders. Assuming that this timetable is met, most insurers will in practice have to start to operate under the Directive from 1 January 2012. If industry is to have sufficient time to implement what will be very significant regulatory and tax changes, it will be necessary to legislate tax changes required in response to Solvency II in Finance Bill 2011.
2. Solvency II has implications for the taxation of both life and general insurance companies. These are described briefly below, but are considered in more detail in the consultation document. Since July 2009 HM Treasury and HMRC have been working informally with representative bodies, individual insurance companies, industry advisers and others to identify and understand these implications.

Life Insurance Companies

3. At the moment, the UK tax regime for life insurers is explicitly based on the current regulatory return that companies are required to file with the Financial Services Authority (FSA). Solvency II will radically change the basis for regulatory reporting. Although the final format of the Solvency II return is far from certain, and is unlikely to be resolved before 2012, it is clear that a number of features of the current return will not be present under Solvency II, so that information necessary to support the present life tax code will no longer be reported for regulatory purposes. Change to that code is therefore inevitable.
4. The initial and fundamental question is therefore what set of numbers should replace the regulatory return as the basis for calculating trading profits for corporation tax purposes. Three possibilities have been identified:
 - To continue with the current basis (but without a return to regulators which would support that mechanism).
 - To use a profit figure, appropriately adjusted if necessary, derived from the Solvency II regulatory return.
 - To use a profit figure, appropriately adjusted if necessary, from the statutory company accounts. These may, in the short term at least, follow either UK generally accepted accounting practice (UK GAAP) or international financial reporting standards (IFRS).
5. The Government's preferred option is the third of these; reasons for this are set out in the consultation document, and are not rehearsed here. Formal consultation is now being undertaken in the following three areas around this proposed change.
6. Firstly, moving to a new basis of calculating taxable trading profits under Solvency II is not the only necessary change. Trading profits are just one component of a wider tax charge on life insurance companies, which seeks to tax not only the profits of the company, but those of some of its policyholders, as they accrue. It is therefore necessary to ensure that implications for the interactions between the trading profits and other elements of the overall tax charge are properly understood and appropriately managed.
7. Secondly, representations have been made, and HM Treasury and HMRC accept, that there is a need to consider whether it is appropriate to modify the pre-tax profit figure reported in accounts to take account of the specific circumstances of long-term insurance business, and if so, how.
8. Thirdly, there are significant transitional issues to be addressed. These revolve around the need to ensure that companies are neither inappropriately disadvantaged, nor inappropriately

advantaged by the change from the old code to a new one. This is not purely a question of taxation; it is also necessary to understand the potential commercial implications of any potential changes.

9. There are problems associated with using the alternatives as a basis for trade profit computations, and although the government's strong preference is to use statutory accounts as the basis, there are also some uncertainties associated with that option. These arise from prospective changes to the relevant accounting bases, which can, or must be used by insurance companies. At present, companies may prepare their accounts either under UK GAAP or under IFRS (although the specific insurance IFRS standards are largely based on local GAAPs – i.e. UK GAAP for most, but not all, insurers operating in the UK). However, current UK GAAP is expected to be withdrawn, probably in 2012. In addition, the current IFRS insurance standard (IFRS 4) is expected to be replaced by a new mandatory standard (IFRS 4 Phase II). This is expected to be effective from 2013; however, there is a possibility that this could be delayed. Although the general shape of the new standard is known, there are important aspects which have yet to be decided.

General Insurance Companies

10. Solvency II is designed to modernise the way in which the solvency of insurance companies is regulated. The aim is to ensure that insurers are financially strong enough to be able to meet obligations to policyholders, even when economic conditions are poor. In essence there are two ways of doing this. Firstly, the company can be required to hold a certain level of capital to back its potential liabilities to policyholders. Secondly, in assessing a company's financial position, prudent assumptions can be made about the amounts which it will have to pay to policyholders in future, and which are recognised in the accounts. Solvency II will see a shift, for regulatory purposes, in emphasis between these mechanisms as well as a better measurement of risks in all parts of the business. For general insurers, the effect is expected to be broadly to increase the level and quality of capital held, while the liabilities recognised will no longer include an element of prudence, and so will fall.
11. General insurance companies, unlike life companies, are taxed on the profits shown in their statutory company accounts, rather than by reference to regulatory requirements. However, it is generally expected that accounting liabilities will reduce in line with regulatory requirements under the new IFRS 4 Phase II standard referred to in relation to life companies. It is a key feature of the tax code that appropriate liabilities serve to reduce profits recognised in a period (effectively the profit on a policy is deferred until it becomes certain), whereas capital held has no effect on profits.
12. Thus there may potentially be a one-off increase in profit levels when recognised liabilities reduce. It has also been suggested that profit recognition might become more volatile. Representations have been received about how the tax code might adjust to this situation.
13. In addition, general insurance companies are currently required by the FSA to establish "claims equalisation reserves" in respect of their more volatile classes of business, particularly those exposed to singular events, such as major climate catastrophes or terrorism. This enables them to build up reserves in periods when low claims are experienced, which can be released to smooth out losses in periods when large claims arise. These reserves do not appear in an insurer's accounts. However, specific rules (Section 444BA to Section 444BD Income & Corporation Taxes Act) permit regulatory claims equalisation reserves to be recognised for tax purposes, allowing for smoothing of volatile profits. Claims equalisation reserves will not be a required feature of Solvency II, and so this smoothing effect will not be available for tax purposes unless particular provision is made; representations have been received that such provision would be appropriate.
14. The government intends to consult in order to understand fully how the taxation of general insurers will be affected by Solvency II and what measures might be appropriate, including proposals already made by the industry in informal consultation.

Costs and Benefits

15. It will be clear from the explanations above that this consultation will be wide in scope. It will also be apparent that, with the exception of the intention to use life company statutory accounts in computing trade profits, the purpose of the consultation is to facilitate further work to establish the costs and benefits of various options under consideration. The costs and benefits of firm options will therefore be set out in more detail at a later stage of the process.
16. For the purposes of this Impact Assessment, and in order to make clear the areas for discussion, a number of options have been identified. However, these are generic in nature. It is not considered helpful, or indeed possible, to attempt to set out all possible permutations at this stage. It is intended that the consultation will help to crystallise and explore specific options.
17. The consultation invites comment on the likely regulatory impact of specific courses of action discussed.
18. In addition to the issues outlined above, the consultation document invites discussion of the possibility of wider reforms to the taxation of life companies. This is not as a necessary consequence of Solvency II. No proposal is made; the government's aim is to explore the possibilities and their implications. This element of the consultation document is not therefore encapsulated as an option, and no attempt is made to assess any impact.

Options

19. Options are discussed individually below.

Option 1: Life Companies - Adopt a statutory accounts basis for tax computations with necessary consequential changes to the life tax code.

20. The trading profits of most life companies do not form the actual basis of the charge to tax, as they do for non-life companies. Rather, the profits are one element which is used in computing the overall tax charge. A change in the method of computing trading profits brings with it certain necessary consequential amendments to ensure that the profit calculation fits with the overall scheme of life company taxation. This option envisages limiting the changes made to those necessary to ensure that the overall scheme can continue to function.
21. All companies, including insurance companies, are currently required by statute (Section 394 Companies Act 2006) to prepare accounts, and this option would not change that. Likewise, companies are required to produce corporation tax computations linking the accounts with the figures included in tax returns, and this would remain the case. No additional administrative burden would be introduced.
22. This option would involve changes to the technical detail included in the tax computations. What these would be would depend on precisely what necessary consequential changes were identified, and this will be a matter for consultation. However, the government does not consider that there is any reason to anticipate that the preparation of tax returns and computations would become more onerous than is presently the case. It is at least as possible that this would become less complex.
23. There would be familiarisation and training costs for both industry and HMRC which are not clear at this stage of the consultation process.

Option 2: Adopt Option 1 with appropriate sector-specific adjustments to accounting profits.

24. This option envisages moving beyond the changes necessary to keep the life tax code working, and encompasses consideration of additional potential adjustments to the accounting profits. Many of these would be adjustments which industry has put forward as being appropriate to the particular circumstances of life companies.

25. As for Option 1, the requirements to prepare accounts and tax computations would be unchanged, so considerations would be as for Option 1. However, a wider range of changes to tax computations could be expected, and there would be familiarisation and training costs, which would exceed those associated with Option 1.

Option 3: General Insurance – Do Nothing

26. It is assumed that this option would of itself neither impose nor relieve any administrative or compliance burdens; companies would simply follow the regulatory and accounting changes. No summary sheet has therefore been prepared.

Option 4: General Insurance - Introduce "tax only" claims equalisation reserves.

27. Claims equalisation reserves are currently calculated for regulatory purposes and made tax effective by specific legislation. Under Solvency II the regulatory requirement will be removed. This option would therefore mean that equivalent calculations would be required, and this would be for no purpose other than tax. The government does not consider that there would be any new additional burden, in the sense that companies would in broad terms be expected to replicate what is done now. It is assumed that necessary systems and expertise are already in place. For the same reason, familiarisation costs are likely to be negligible.

28. It is also noted that this option would be in line with industry representations received to date.

Option 5: General Insurance - Introduce measures to modify the effects of changes in reserving, either alongside or instead of Option 3.

29. Although this option does not at present constitute a specific proposal, it is thought likely that any outcome would impact at the tax computation, rather than the operational, level. Any familiarisation and training cost is considered to be small or negligible.

Specific Impact Tests

Competition Assessment

30. We have considered this measure against the competition filter developed by the Office of Fair Trading. Nothing proposed in the measure will impact on the ability or incentive of any business to enter markets or compete within them.

Small Firms Impact Test

31. We are required to consider the impact of proposals on firms with less than 20 employees. Solvency II will affect all insurance companies, and all life companies will therefore need to change the way in which trading profits are computed. There can therefore be no exemption in respect of the proposal to base these on company accounts. Further, it is thought that there are very few, if any, insurance companies employing fewer than 20 people. The group most likely to fall into this category would be Friendly Societies. We will be using existing contacts with the body representing that sub-sector to identify any particular issues of concern.

Other Specific Impact Tests

32. We have completed the initial screening tests in the following further areas, and concluded that they are not impacted by this measure:
- **Legal Aid.** There will be no need for new criminal sanctions or civil penalties.
 - **Sustainable Development.** Any changes will be in accordance with principles of sustainable development.
 - **Carbon Assessment.** Nothing in this measure will impact on carbon emissions.
 - **Other Environment.** Nothing in this measure will impact on the environment.

- **Health.** Nothing in this measure will have a significant impact on health as defined in Department of Health guidance.
- **Race, disability and gender and Human Rights.** We have carried out an initial equality impact assessment, and conclude that there is no evidence of any adverse equality effects.
- **Rural issues.** There will be no impact specific to rural communities or areas.

Specific Impact Tests: Checklist

Use the table below to demonstrate how broadly you have considered the potential impacts of your policy options.

Ensure that the results of any tests that impact on the cost-benefit analysis are contained within the main evidence base; other results may be annexed.

Type of testing undertaken	<i>Results in Evidence Base?</i>	<i>Results annexed?</i>
Competition Assessment	Yes	No
Small Firms Impact Test	Yes	No
Legal Aid	Yes	No
Sustainable Development	Yes	No
Carbon Assessment	Yes	No
Other Environment	Yes	No
Health Impact Assessment	Yes	No
Race Equality	Yes	No
Disability Equality	Yes	No
Gender Equality	Yes	No
Human Rights	Yes	No
Rural Proofing	Yes	No



Introduction to I-E

There are a number of different types of long term business written by a life assurance company, although for tax purposes there are three main categories: gross roll-up business (GRB) (such as pension business), basic life assurance and general annuity business (BLAGAB) and permanent health insurance (PHI). Each of these is treated differently by the tax system. The most significant difference is that, for BLAGAB business, the tax system seeks to tax the return to policyholders as it accrues.

A company carrying on life assurance business is carrying on a trade. Where a company has no BLAGAB business it is charged on its trading profits in the normal way. Thus, the premiums and the return on investments made from investing those premiums are included as incomings. The expenses and claims (amounts paid on death, maturity or surrender) are included as outgoings, and a provision is allowed for future claims (the technical provisions or policy reserves). Since the technical provisions include the value of the net investment return accruing on the policies for policyholders, that part of the investment return is not taxed. All that is taxed is the profit accruing to the shareholders of the company. That is appropriate where, for instance, the company only writes GRB business.

However, where a company writes BLAGAB business the UK system also taxes the policyholders' investment return as it arises. This is done by applying the "I-E basis" to the taxation of the company.

The I-E Basis Explained

BLAGAB

The I-E basis taxes a company carrying on life assurance business (which includes BLAGAB business) on its income and chargeable gains arising or accruing from the life assurance business (the I) and gives relief only for the expenses incurred by it in managing its business (the E). Thus in addition to taxing an amount representative of the shareholders' operating profit, because no relief is given for technical provisions, the part of the investment return after expenses that accrues for policyholders is also taxed as it accrues.

That this is the effect of the I-E system can be best be demonstrated algebraically–

A life company's incomings and outgoings consist of: -

Premiums	P
Investment income & gains	I
Expenses	E
Claims (including reserve for future claims)	C

The shareholders' profit will be the company's incomings, that is premiums and income and gains, less outgoings, that is expenses and claims. It can therefore be expressed in the following formula:

$$\begin{aligned} \text{The shareholders' profit (SP)} &= P + I - E - C \\ \text{Therefore SP} &= I - E - (C - P) \end{aligned}$$

The policyholders' return from policies (PP) is the difference between claims (i.e. the proceeds in the hands of the policyholders) and the premiums paid by the policyholders. In terms of a formula:

$$\text{The policyholders profit (PP)} = C - P$$

Combining the two, so that the Shareholders Profit and Policyholders Profit are taxed together:

$$SP + PP = I - E - (C - P) + (C - P)$$

Therefore:

$$SP + PP = I - E$$

Clearly, this relationship only holds true over a period of time. The nature of long term business means that often premiums are received long before any claim or maturity of a policy, but over the full cycle of a life business the effect should be to tax both the shareholder and policyholder profit. It is also notable that the relationship holds true even where the policyholder or the shareholder makes a loss.

GRB

Since the policyholders' return for GRB business is intended to be exempt from tax, to avoid the I-E computation taxing that policyholder return all of the components of I-E related to GRB are left out of account. Instead, the trading profit in respect of GRB is calculated separately, thus providing a measure of the shareholder profit in respect of that business, and this is added to the I-E result.

So I-E profits consist of both the policyholders' and shareholders' income from BLAGAB, but the shareholders' income alone from GRB.

PHI

Although PHI is accounted for in the same fund as other life assurance business, it is treated separately for tax purposes. The effect is that a company taxed under I – E which also writes PHI will be taxed separately on the trading profits from PHI business.

Apportionment

In general a company carrying on life assurance business does not have separately hypothecated or earmarked funds for each type of business. Instead it has at least one Long Term Insurance Fund (LTIF), which by virtue of regulatory rules it is required to establish separately from other funds (such as shareholders' funds). A division has to be made for tax purposes of the elements of the fund (premiums, claims, expenses and particularly investment return) so that the profits, income or gains of each type of business can be properly calculated. As far as the elements other than investment return are concerned, this is normally done on the basis of factual allocation.

For investment income and capital gains the allocation is done by way of apportionment. Income and gains on assets are directly attributed to particular types of business insofar as that is possible. The remaining assets and income are allocated on the basis of a formula that uses liabilities to policyholders in the various categories of business as its main determinant.

Where it is a question of calculating the profit arising from GRB business there are a variety of different apportionment rules that can apply. These rules apply at fund level, and can apply differently according to whether the business in a fund is with-profits or non-profit. The objective is to allocate an appropriate investment return to the relevant categories of business, which is then treated as a trading receipt (or expense) in the trading profit computation.

The basis of this apportionment exercise, and of all computations of trading profits in respect of life assurance business, is the regulatory return produced for the FSA by all life insurance

companies. They are required to draw up a “revenue account” in which they record investment income and gains, premiums, claims and expenses relating to each fund. This prescribed revenue account or Form 40 is central to the use of the return made to the FSA, in computing tax liabilities.

The Rate of Tax

The shareholders’ share of the I-E result is taxed at the normal corporation tax rate. The policyholder return is taxed at a reduced rate of 20%. To establish the respective elements of the overall result, the trading profit of the business as a whole is calculated, and is taken to represent the shareholders’ share.

Adjustments to the I-E Basis

The fact that shareholder and policyholder profits are calculated in one single result can give rise to anomalies, and there are specific life tax rules designed to address some of these.

The I-E result may sometimes be less than the trading profit in any given year. In such a case the overall result reflects the fact that when a policyholder loss is made there may still be a shareholder profit. To avoid policyholder losses being offset against shareholder profits in such circumstances, there is a rule which provides that the I-E charge is increased by imputing a deemed receipt, so that shareholder profits are fully taxed. An amount equal to the imputed receipt is then treated as an expense carried forward to the next period of account.

HM Treasury contacts

This document can be found in full on our website at:
hm-treasury.gov.uk

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