

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

2 June 2010

Dear Andy,

ILAG response to HM Treasury/HMRC consultation on Solvency II and the Taxation of Insurance Companies

I am writing in response to this consultation paper on behalf of ILAG. Our overall objective in our response is that the outcome of the Consultation Document should not materially adversely impact on our members in respect of the compliance or tax burden. We hope to continue to engage with HMT/HMRC in a productive manner to help achieve this.

ILAG represents members from the Life Assurance and Wealth management industries. ILAG members share and develop their practical experiences and expertise, applying this practitioner knowledge to the development of their businesses, both individually and collectively, for the benefit of members and their customers.

ILAG has a wide range of mainstream members drawn essentially from the life assurance, pensions and investment industries representing firms across the spectrum that are diverse in size, scale and status. In addition we have an extensive field of associate members who offer business support and service in many different ways to mainstream members.

Our comments are set out below and follow the numbering of questions contained in the Consultation Document.

CHAPTER 2 – A NEW BASIS FOR THE CALCULATION OF TRADING PROFITS

Source of profit under an accounts basis

[2.9 Comment is welcome on the starting point for the determination of life assurance trade profits set out in paragraph 2.8 including where there might be circumstances](#)

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where a different figure for the accounts would be more appropriate (for example to take account of exceptional items).

We acknowledge and accept that the starting point for the determination of life assurance trade profits is the profit shown in the financial statements. However, the important issue is not so much the starting point but that the amount that gives rise to taxable profits (after appropriate adjustments have been made) reflects the unique nature of life assurance companies' profits. This is that the business is of a long term nature with profits being shared between its customer policyholders and shareholders. Because of the long term nature of the business the allocation of the profits between policyholders and shareholders is not fixed at a particular point in time such as the date when the accounts are drawn up.

ASB Proposals on Future of UK GAAP

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 are any categories of life company which would not fall to be classified as "publicly accountable".

It is our understanding that life companies will be public accountable companies.

Impact of Solvency II on Financial Statements Technical Provisions

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.

It is our understanding that insurance companies do not necessarily have to use the liabilities calculated under Solvency II calculations in their financial statements. There are a range of options and different companies may use different approaches. At this stage, it is likely that many companies have not yet determined which approach to adopt.

IFRS for Insurance Contracts – Phase II

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) above, 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 profits in quick succession, and on ways in which any adverse impact may be mitigated.

A special transitional regime is justified where the accounting change has a significant impact to ensure that items are neither taxed twice nor omitted from tax. A special regime is particularly important given that the basis may change a number of times and could result in an irregular profile of results. It is important that transitional items are brought into charge to tax at an appropriate point in time.

There are also the practical aspects of possible multiple changes on systems and the compliance burden with associated extra costs. Changes in the underlying pricing systems to take account of such changes can take months to implement.

The normal rules for changes in accounting rules are not suitable for the extent and scope of these changes.

While the impact of the move from IFRS Phase I to IFRS Phase II is difficult to assess since IFRS Phase II has yet to be finalised and, as such, the size and scope of its impact is not yet known, the impact is expected to be significant. Moreover, the basis for calculating current year and deferred tax will change and result in volatility in the tax charge and prior years will therefore need to be restated. In addition there will be issues in establishing the appropriate tax treatment in the pricing of new products and the impact of a different tax treatment to that factored into the pricing of in-force business.

Companies are particularly concerned about the possibility of a large cash tax bill without any actual real (cash) increase in profits.

Transition from FSA Return to Accounts Basis

[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](#)

For certain types of business it is possible that a move to an accounts basis will result in a release of mathematical reserves. The consequent impact on the taxable profit of a life insurance company should not be taxable immediately to the extent that the amount is required to be retained for the protection of policyholders.

Other transitional arrangements should include provision that losses and other tax assets brought forward from the “old regime” are capable of relief in the “new regime”. This would include GRB and LATP losses and tax attributes such as spread acquisition expenses and CGT losses.

Tax adjustments to Accounts Profits

[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?](#)

Our view is that we should arrive at a tax base that is broadly similar to the current one. This will mean applying adjustments to the trading profit shown in the financial statements to reflect the special nature of the life company business – long term nature of the contracts and sharing profits between its policyholder customers and shareholders. This will ensure continuity and recognise explicit provision to deal with the changes in the accounting regime.

The adjustments we consider are required in respect of life assurance trade profits include the following:

- deduction for policyholder taxes
- deduction for policyholder bonuses

- an exemption for amounts retained for the protection of policyholders due to Court Schemes and FSA directions.
- exclude movements in deferred acquisition costs
- income and gains on structural assets
- deduction for any Solvency II technical liabilities in excess of accounting technical liabilities
- exemption in respect of the shareholder's share of BLAGAB dividends
- if a UDS/FFA is not retained in the move to IFRS 4 Phase II, a tax deduction for the equivalent of what would have been a transfer to UDS/FFA.

Volatility

2.28 To what extent does the FFA/UDS mitigate volatility for with-profits business

How might this change under IFRS 4 Phase II

The FFA/UDS reflects the difference between the cumulative value of the long term fund and the value of policyholder liabilities including accumulated declared bonuses. The volatility of the with-profits business is smoothed by the life company allocating the required level of bonuses to policyholders based on a long term view rather than allocating the entire result of the with profits fund of that particular year.

The treatment of UDS/FFA has not yet been determined as part of the IFRS Phase II project. However, we consider that there should be a deduction for the equivalent of the transfers to UDS/FFA if they are removed in 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

We are not seeking mitigation for such ongoing volatility in fee income.

However, there may be volatility caused by an accounting mismatch between IFRS assets and liabilities. A good example is that under IFRS, sterling reserves for investment contracts are not required to be held as they are under the current regulatory regime. This will give rise to a one-off profit that will be subject to tax. This profit should be considered for spreading over an appropriate period.

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?

The two main products sold by the life industry on a non-linked non profit basis are annuities and protection business. For annuity business, there is exposure to the credit risk. It is possible under the current regulatory regime to include a liquidity risk allowance in valuing liabilities in the FSA returns. If no liquidity risk is allowed under Solvency II, there will be significant volatility in the results.

Additionally under IFRS II, the discount rates used to value the liabilities will not be directly linked to the yields on the actual assets held to back the annuity business giving rise to more volatility than currently experienced.

It is considered that there should be a form of equalisation mechanism that recognises this volatility. There should be a change to the current 1 year carry back rules in order to ensure that significant trapped losses arising from this volatility are avoided.

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

In addition to those referred to in 2.20 above, there are a number of other areas where volatility will arise including

- (i) The accounts do not have an investment reserve and so the full movement in investments is reflected without a corresponding increase in liabilities for non profit business.
- (ii) For protection business under IFRS the discount rate to be used is based on the liability rather than the assets held to back the liability.
- (iii) For annuity business there could be a greater mismatch between the value of assets and the valuation of the liabilities.
- (iv) Under IFRS 4 Phase II, movements in UDS/FFA may be included in the IFRS profit for the year.

What might the impact of any such increased volatility be?

The current system taxes both shareholders and policyholders. Significant volatility in the results used as a base for the tax system may lead to disproportionate amounts being levied on policyholders and shareholders in any particular year in an industry that is, by its nature, long term.

The volatility may give rise to profits in one year followed by losses in later years which may not necessarily obtain relief at a later stage.

What the measure might be to mitigate any adverse impact

The following are examples of measures that could help mitigate the impacts.

- (i) The use of a type of equalisation reserve for tax purposes to smooth the impact of the volatility.
- (ii) A longer period than the present 1 year over which losses can be carried back.
- (iii) Group relief of XSE between life companies.
- (iv) Carry back of XSE.

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

The life industry is unique in that it is a long term business with profits being allocated between its customers, the policyholders, and the shareholders. The allocation of the profits earned over a long term does not fit well with determinations of profits for tax purposes at regular intervals at year ends. The final profit is not known until the policy ends.

Availability of profits

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

The Companies Act recognises that for a life group, distributable profits (profits available for shareholders) are measured on a different basis from other companies. Amounts allocated to policyholders and carried forward unappropriated amounts should not be included in realised profits that are available for shareholders

As noted above, the participatory nature of some contracts means that not all the profits arising in an accounting period accrue to shareholders and some are retained to protect policyholders' interest. In addition, the long term nature of the business means that profits arising in a single period are not a true reflection of the overall profit that will emerge over the life of the contract.

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?

There may be in place arrangements either with a Court or the FSA that require the profit to be retained for protection of the interests of policyholders. Such amounts should not form part of taxable profits of the insurer.

Under Solvency II, where the technical provision is higher than that shown in the accounts, the accounting profit equal to the excess is not available to shareholders because of regulatory constraints and a tax deduction for the additional policyholder liabilities should be given.

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

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

How do these 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?

The exact nature of the FFA/UDS will depend on the insurer's accounting policies, its PPFM, any Court Schemes and the commercial interplay between policyholders and shareholders.

Permanent Health insurance

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

The move to an accounts based tax regime offers the opportunity to consider the tax treatment of PHI business, although we would not see this as one of the priorities of this consultation exercise.

Shareholder Assets

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?

Our understanding of this question is that it relates to assets which under the current regulatory regime are held in the shareholders' fund. We do not see the move to an accounts based tax regime as a reason to change the current treatment which, in the absence of a regulatory or accounts allocation, would be based on the company's underlying records.

Quantum of I-E Profits

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?

There may be a number of ways of addressing the issue. Examples are the ability to group relief XSE to other life companies or to carry back XSE against excess I of earlier periods.

Allocation of Amounts to be taxed at Policyholder and Shareholder Rates

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

We see no need for a change in the basis of determining the policyholders' share of life assurance profits.

Mutual Companies

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?

The overriding I principle for mutual companies and friendly societies arising from this consultation exercise should be to maintain their existing tax profile and tax contribution.

There are concerns that the basis that may be derived to deal with proprietary companies may have consequential impacts for mutual companies and friendly societies, particularly in respect of the computation of GRB profits. It is well established under the current rules for the mutual sector that the GRB profit generally only comprises fiscal adjustments. This is due to the current apportionment rules and is a reasonable result conceptually as profits generated can only be allocated to policyholders.

If any revised apportionment rules or a failure to allow a deduction of profits that will be allocated to policyholder in the future give rise to a profit for GRB then it maybe that a further measure, relevant only to mutual companies and friendly societies will be necessary in order to preserve what is a fair basis of taxation.

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?

A detailed response has been made to this question by the Association of Financial Mutuals (AFM) and we defer to their views.

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

Any new apportionment rules need to continue to accommodate tax exempt life or endowment business and tax exempt other business carried on by Friendly Societies. In addition the rules need to continue to accommodate tax exempt life assurance business and tax exempt other business carried on in insurance companies.

Income and Chargeable Gains referable to BLAGAB

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

Although the distinction between LTIF and other assets may not be reported in the financial statements, the underlying records are expected to still show this. It is not yet known whether the distinction will be a feature of the Solvency II regulatory return.

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?

As stated above in 2.60, it is expected that this information will be obtained from the company's underlying records.

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?

We presume that a simple mean liability basis would retain directly referable treatment for linked business. It is not yet clear how the use of a simple mean liability basis for non-linked business would compare with the current method. Further research will be required following the QIS 5 report on the valuation of technical provisions under Solvency II and this topic should be discussed in the working groups.

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

The current basis should continue with the necessary adaptation required for it to be applied to the IFRS measure of investment return.

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

We do not consider that a single apportionment rule would produce a more reasonable result than the current method. Any changes beyond what is necessary to enable the current regime to operate using IFRS based figures would require a more fundamental review than is feasible in the current circumstances.

2.63 Are there any opportunities to extend direct allocation?

Whilst direct allocation of certain items may be possible in some cases we think it is unlikely to be practicable for the entire industry. However, it may be possible to consider for those companies who are able to achieve a form of direct allocation, the prospect of making an irrevocable election to use direct attribution for non linked income and gains.

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?

No. There would be many practical difficulties in implementing this. In particular the income and gains reported in the accounts will not be readily identifiable with the underlying income associated with the investment contracts concerned.

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

Some companies do distinguish non-linked items as between BLAGAB and other business. However, this is not universal and is therefore unlikely to be feasible as a basis for tax.

CHAPTER 3 - GENERAL INSURANCE

The main issue for our members will be the transitional reliefs or adjustments required if there is likely to be a significant movement in reserves. A transitional period of up to 10 years for the release of liabilities is likely to be appropriate.

We would also like to see a flexible and effective mechanism to replace the current claims equalisation reserve system, to smooth taxable profits of general insurance companies and help to reduce the risk of trapped losses.

CHAPTER 4 – POTENTIAL WIDER REFORM TO I-E

In our view there is insufficient time because of the systems implications and the amount of change currently underway in the regulatory and financial reporting environment for a proper reform of the I-E system before Solvency II is introduced. If there is a reform of I-E at some stage in the future, then in order to be consistent with the principles of Treating Customers Fairly (TCF), grandfathering provisions should be introduced to protect the tax treatment of existing business written prior to the introduction of any change to the current I-E regime. We view this as essential.

We would be happy to discuss further any of the items raised by our response.

Yours sincerely

Graham Wilson
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