

Clients & Friends Memo

The UK Budget 2011 – Spotlight on Insurance

30 March 2011

On 23 March 2011, the Chancellor of the Exchequer announced a number of measures which will both directly and indirectly affect the UK tax treatment of insurers. We have set out a summary of the relevant changes below.

Overview

While the UK insurance sector will no doubt be welcoming the forthcoming 2 per cent. reduction in the main rate of corporation tax in April 2011, there are a number of sector-specific areas in which further changes have been announced (which are covered in more detail below).

In terms of the ongoing reforms to the UK's corporate tax regime, there was a welcome announcement that some life insurance business conducted by overseas branches of UK insurers could qualify for the elective branch profits exemption to be introduced in Finance Bill 2011. It is now proposed that long term business, which is not basic life assurance and general annuity business ("BLAGAB"), will be eligible for the overseas branch profits exemption as well as general insurance business.

The reduction in the proposed rate of corporation tax on apportioned overseas financing income under the new CFC regime to one-quarter of the main rate (i.e. 5.75 per cent. from 2014) is also likely to be of interest to insurers.

However a number of changes specific to the insurance sector have been announced in Budget 2011, which flow from the impending implementation of Solvency II and a professed desire on the part of the Government to simplify the UK tax regime for insurers. These changes are likely to have a significant impact on the internal models and provisioning calculations of insurance companies.

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Life business*Solvency II changes*

The advent of Solvency II, and the new regulatory framework for insurance undertakings which will follow, resulted in a consultation by the Government in relation to the impact of Solvency II on the UK taxation treatment of life insurers.¹

A number of changes have now been announced by the Government in anticipation of the introduction of Solvency II:

- Calculation of trade profits. The Government has announced that, further to the proposals it first published on 10 March 2010, the trading profits calculation for life insurance companies will now be based on the profit before tax reported in the company's statutory accounts and not the surplus reported in the insurer's FSA regulatory return (which will change as a result of the introduction of Solvency II). The reported profit will be adjusted to remove any credits or debits for tax attributable to the long term business of a life insurer included in the technical and the non-technical account.²

An excess of the value of assets over liabilities arising from with-profits business which has not been allocated may currently be held in a fund for future appropriations (FFA, under UK GAAP) or an unallocated divisible surplus (UDS, under IFRS) and treated as a liability.³ The Government has stated that deductions will still be available with respect to FFAs and UDSs after the introduction of Solvency II, but it is as yet unclear what impact IFRS 4 Phase II will have on this position.

Legislation will be introduced to make policyholder bonuses deductible for tax purposes, in line with current practice, as the authorities in this area point to such bonuses constituting non-deductible appropriations of profit.

Further consultation is expected in relation to the tax deduction which will, in principle, be available for policyholder tax. The Government's current preference is that the deduction should be based on cash tax payable at policyholder rates without regard to tax which may become payable in future. However, suggestions are invited from life insurers for a measure which includes deferred tax and which is, in the Government's words, "simple, consistent between companies, transparent and clearly linked to tax actually payable at policyholder rates".

¹ Solvency II is currently expected to come into force 1 January 2013.

² Where accounts are prepared under both IFRS and UK GAAP, the profit figure will also be adjusted for taxable items of income and expense included under other statements in the accounts (including the Statement of Recognised Gains and Losses and the Statement of Changes in Equity).

³ There is however uncertainty surrounding the development of IFRS 4 and concerns exist as to the scope of the UDS and the potential for increased profit volatility.

- Taxation of assets. Given that Solvency II appears unlikely to continue the regulatory requirement to distinguish between shareholder fund assets and assets held within the long term insurance fund, the Government is considering basing the taxation of insurance companies' assets on the fixed or circulating nature of the capital. This is likely to lead to the need for detailed guidance as to how the distinction is to be applied in practice, not least because the distinction is based around long-standing case authorities.
- Transitional rules. Transitional rules will be introduced to smooth the effect of moving to a more accounts-based approach. Deferred acquisition costs⁴ will not be relieved on an accounting basis where they have already been written off in the current regulatory returns. Conversely, deferred income reserves⁵ representing income which has already been recognised in the regulatory return will be ignored to avoid double taxation.

Where restrictions have been imposed as a result of court schemes,⁶ amounts which have been recognised as profits in the accounts and not in the regulatory return (and which are subject to restrictions on distribution by the court scheme) will be brought into charge over 10 years. Where there is an absolute bar on distribution of these amounts, the transitional taxation will be deferred for two years or until the date of removal of the bar (if sooner). The fall-back position for other adjustments needed as a result of differences in the timing of recognition of profits for tax purposes will be that those adjustments are brought into account over 10 years.

Losses from gross roll-up business will be carried forward against the trading profits of the new combined category of gross roll-up and permanent health insurance business. However losses from permanent health insurance business may be subject to streaming and the current streaming of losses within gross-roll up business may also continue for pension business losses carried forward into the new combined category (the Government will consult on both these questions). Excess BLAGAB expenses will be available for carry forward into the I-E computation under the new regime and a proportion of BLAGAB life assurance trade losses will be available for carry forward against trade profits for the purposes of the new "minimum profits test".⁷

The I-E basis

The Government intends to remove "protection" life assurance business from the scope of the I-E computation and bring it within the category of long term business to be taxed on a trading profits basis. The change will affect the treatment of profits from policies which provide no separate investment element in addition to life cover and will have effect from 1 January 2013 in relation to policies written after that date. Further consultation is expected as to how

⁴ I.e. the costs of securing new business which are spread over a number of years in the accounts of the company.

⁵ I.e. the income received at the outset of certain policies which is recognised over a number of years in the accounts of the company.

⁶ As a result of a need to balance the interests of shareholders with the interests of with-profits policyholders.

⁷ It is not yet clear how this proportion will be calculated.

“protection business” is defined for these purposes. It is also intended that gross roll-up business will be excluded from the scope of the I-E computation from 2013.

For profits remaining within the scope of the I-E computation, a minimum profits test will continue to apply with the intention that the amount brought within charge under the I-E basis should be at least as much as the life company’s BLAGAB trading profit.⁸

Business categorisation

From 2013, the categories of long term business recognised for tax purposes will be reduced to two. Currently, three categories of long term business are recognised: BLAGAB, gross roll-up business and permanent health insurance. However, since the measure of profits from both permanent health insurance and gross roll-up business will be the accounting profit (in each case) from 2013, these categories will form part of a category taxed on the basis of trading profits with BLAGAB continuing to be dealt with separately.

Transfers of long term business

The taxation rules governing transfers of long term business will be simplified (and subject to a new consultation). The new rules will be based on the principle that the accounting treatment of arm’s length transfers will be respected. Accounting profits and losses for transfers of business between connected parties will be ignored, with all profits and losses on the insurance contracts being taxed in the hands of the transferee as they emerge (i.e. a “stand in shoes” treatment on transfer). The simplification will be accompanied by an anti-avoidance rule.

Apportionment rules

Changes to the life assurance apportionment rules will be included in Finance Bill 2011. The Government’s intention is to align tax apportionments more closely with commercial reality with the welcome offer of agreements with customer relationship managers to achieve certainty as to what an appropriate approach would be in each case to achieve this. Further consultation is expected in this area.

Taxation of dividends

A consultation will be launched on the taxation of dividends in the hands of life companies, with a particular focus on dividends attributable to gross roll-up business (which are currently taxable in full).

Mutuals

No changes to the principles underlying the tax treatment of mutual business are envisaged as a result of the introduction of Solvency II.

⁸ From 2013, only BLAGAB will fall within the scope of the I-E basis.

Non-life business

General claims equalisation reserves (CERs)

General insurers are currently required to maintain CERs. CERs are made tax effective by reference to the regulatory requirement. Since these requirements will be superseded by the introduction of Solvency II, the relief will no longer be tax effective.

The Government is currently minded to legislate to continue the relief, but has asked industry to give a “robust justification” for the retention of CER relief. To a certain extent the outcome will depend upon the development of IFRS 4 and the implications of Phase II on profit volatility.

In the event that the Government decides not to renew the relief, there will be a six-year transitional period over which reserves are released.

Lloyds corporate members – stop loss and quota share insurance

The legislation providing for the deductibility of stop loss premiums is not clear when it comes to ascertaining the timing the deduction. HMRC had previously taken the view that premiums paid by corporate members would be deductible on a declarations basis. However, industry participants have asserted that the correct position under the legislation is that such premiums should be deductible on an accounts basis and HMRC has now changed its view accordingly. Draft legislation will now be published for consultation (and for inclusion in Finance Bill 2012) in order to ensure that the timing of deductions for stop loss premiums is linked to the profits to which they relate.

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