Life Tax

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Agenda

- I minus E regime:
  - Refresher
  - Special rules
  - Acquisition expenses
- BLAGAB Reinsurance changes
- IFRS 17 Transition
- HMRC Life Assurance Manual – friendly societies chapter

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I-E regime: Refresher

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Taxation of life insurance – Overview

- Life tax regime was changed with effect from 1 January 2013, moving the basis of taxation from the regulatory return to the accounts
- The majority of the rules are contained in Finance Act 2012 and in particular splits the life assurance business into three separate categories:
  - Basic Life Assurance and General Annuity Business (BLAGAB)
  - Non-BLAGAB
  - Tax exempt business (Friendly Societies only)
- The rules also split out certain assets to be treated as Long Term Business Fixed Capital and not part of the life assurance business
- The business must use an "acceptable commercial method" to allocate taxable items between its various categories of business on a basis which is "fair"
- In practice this is usually agreed with HMRC in writing and will need to be updated if the business changes

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Categories of business

Non-BLAGAB

- 'Tax favoured':
  - Pensions, ISAs, child trust funds
  - Investment return on these policies rolls up gross of tax
- Other specific types of business:
  - Overseas
  - Life reinsurance
  - Protection business written after 1 January 2013

BLAGAB

- The 'other one':
  - Anything that is life assurance business but which isn't non-BLAGAB

Or

  - Is capital redemption business

Tax exempt Friendly Society business

- A friendly society is not chargeable to corporation tax on its profits arising from "exempt BLAGAB or eligible PHI business", but it must make a claim for this exemption to apply (in its corporation tax return)

Tax treatment

- Taxed on a trade profit basis only (therefore not brought into tax for mutual life assurance companies or friendly societies)

Tax treatment

- Subject to income minus expenses (I-E) regime and minimum profits charge when assessed using a trade profits basis

Tax treatment

- Exempt business is generally business falling under certain annual premium limits, currently £270 with some additional caveats

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I-E regime

- BLAGAB business subject to I-E regime:
  - I-E really means income plus gains minus expenses
  - Exception where ‘substantially’ all business is non-BLAGAB
- Why I-E?

Policyholder (PH) profit = claims (C) — premiums (P)

Shareholder (SH) profit = premiums (P) + investment return (I) — expenses (E) — claims (C)

= — (C + E — P — I)

SH profit = — (PH profit + E — I)

I — E = SH profit + PH profit

- I-E really does tax total PH and SH profit
- I-E replaces ‘normal’ trade profit calculation
- Ultimate tax charge is still corporation tax

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I-E regime

- As the members of a mutual insurance company are its policyholders, the entire I-E is attributable to policyholders
- The policyholders' share of the I-E profit – so for a mutual, all of it – is subject to corporation tax but at a rate equal to the basic rate of Income Tax (BSR)
- In summary, the objective of the I-E basis for a mutual life assurance company is to collect tax from the life company on the investment return accruing for the benefit of policyholders on BLAGAB policies

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BLAGAB I-E

- I-E calculation in six steps

Step	Description
Step 1	Income chargeable
Step 2	Chargeable gains adjusted for allowable losses
Step 3	Sundry receipts and any charge arising from the minimum profits (MP) test
Step 4	Add steps 1–3
	Less: deficit on loan relationships and derivatives (but not below nil)
	The result is ‘I’
Step 5	Adjusted management expenses (includes prior period XSE and MP charge) ‘E’
Step 6	Subtract E from I: I-E profit/(XSE)

- Only items commercially allocated or matched to BLAGAB

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BLAGAB I-E: Steps 1-4 – Taxable income and gains

Asset Class	Taxation of income	Taxation of gains
UK equities	Dividends not taxable	Realisation basis
Overseas equities	Dividends not taxable since 2009	Realisation basis
Property	Rental income taxable	Realisation basis
Gilts and bonds	Interest income taxable	Realised and mark to market basis
Collective investment schemes	As above depending on underlying asset	Fixed interest trusts – same as gilts and bonds Equity and property trusts – deemed disposals (see later)
Derivatives	Generally follow treatment above based on underlying asset, but rules can be complex	

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BLAGAB I-E: Step 5 – Relievable BLAGAB expenses

Expense type	Relievable expense
Acquisition expenses	Yes, but see later
Maintenance expenses	Yes
Investment expenses	Yes, if not capital in nature
Amounts paid to policyholders including compensation	No, specifically excluded
Other expenses	Possibly

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I-E Regime: Special rules

XSE relief

- Step 6 is to subtract “E” (step 5) from “I” (step 4)
- If the result is negative, the negative amount is referred to as “excess BLAGAB expenses” (also referred to as “XSE”), which is carried forward to the next accounting period for inclusion at step 5
- The CT loss restriction rules do not apply to XSE

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Loan relationship deficits

- Loan relationship credits and debits referable to BLAGAB are deemed to be non-trading for I-E purposes (s88(2) FA12)
- If there is a net credit from loan relationships, the net credit is brought into step 1 income
- If there is a net debit (a “deficit”), this is first set against income at step 4 with any remainder carried backwards against net credits in the past 3 accounting periods that ended within the 12 months preceding the current accounting period on LIFO basis before the residual is automatically carried forward as deemed management expenses of the next period (for inclusion at step 5)
- In practice this usually means losses can be carried back one year for companies who’s previous accounting period is one year long

BLAGAB I-E: Step 2 – Deemed disposals and loss relief

- Applies to life company investments in collective investment schemes (including authorised unit trusts, OEICS, offshore funds, authorised contractual schemes and Real Estate Investment Trusts)
- Anti-avoidance measure - rules aim to ensure that gains are not indefinitely deferred by holding investments within collectives, such as UK equity OEICs, that are exempt from tax on chargeable gains
- A disposal and immediate reacquisition is deemed to take place at market value at the end of the accounting period
- Deemed gains/losses are spread over 7 years
- Ability to carry back losses (see next slide)

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BLAGAB I-E: Step 2 – Deemed disposals and loss relief

Period	Deemed gain/(loss)	Loss carry back	Revised gain/(loss)	Untaxed amount b/f	Current year	Year +1	Year +2	Year +3	Year +4	Year +5	Year +6	Untaxed amount c/f
Year -6	3,500	0	3,500	500	500							0
Year -5	(1,400)	0	(1,400)	(400)	(200)	(200)						(200)
Year -4	2,940	0	2,940	1,260	420	420	420					840
Year -3	3,990	(1,540)	2,450	1,400	350	350	350	350				1,050
Year -2	1,400	(1,400)	0	0	0	0	0	0	0			0
Year -1	(2,940)	2,940	0	0	0	0	0	0	0	0		0
Current year	6,440	0	6,440	n/a	920	920	920	920	920	920	920	5,520
Net gains/(losses)				2,760	**1,990**	1,490	1,690	1,270	920	920	920	7,210
Gross gains				3,160	2,190	1,690	1,690	1,270	920	920	920	7,410
Gross losses				(400)	(200)	(200)	0	0	0	0	0	(200)

- Deemed disposal losses can either be spread in the same way as gains (as shown for Year -5 in the above example) or alternatively the company can elect to carry them back and offset them against deemed disposal gains of the previous 2 years on a LIFO basis before applying the 7 year spreading (as shown for Year -1 in the above example)
- Making a carry back claim does not affect tax payable in the year of carry back (i.e. Year -1 in the example). It reduces the tax payable in the years carried back to (Years -2 and -3 in the example) and increases the tax payable in future periods (current year and Years +1 to +5 in the example)

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I-E Regime: BLAGAB acquisition expenses

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BLAGAB acquisition expenses

- Acquisition expenses are defined in section 80 of FA12 but generally include commissions and other costs incurred (wholly or partly) to acquire business
- Many expenses meeting the definition will also, for accounting purposes, be capitalised and amortised as DAC on the balance sheet (but not necessarily)
- The acquisition expenses were previously spread over 7 years (starting with the year in which any part of the expenses was debited in the accounts)
- For both UK GAAP and IFRS reporters, changes have been made to the life tax regime whereby tax relief in the I-E calculation for new acquisition expenses incurred from 2023 will be on a "follow the accounts" basis rather than being spread over a 7 year straight line basis
- This is intended to be a tax compliance simplification for all life companies

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BLAGAB Reinsurance update

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BLAGAB reinsurance – refresher of the current rules

- Prior to 1995, it was possible for a company in an I-E profit position to reinsure BLAGAB business to an offshore or XSE company so that some or all of the investment return fell outside of the I-E regime
- From 29 Nov 1994 anti-avoidance measures were brought in (and broadly replicated in the FA12 re-write of insurance tax rules) to prevent this
- The rules work by imputing an investment return in the cedant as I-E income in Step 1 of the I-E calculation, unless the cedant falls within one of the exemptions set out in the regulations referred to as “excluded business”
- In the reinsurer any business subject to the imputed I-E investment return in the cedant will be treated as non-BLAGAB long term business subject to trade profits

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BLAGAB reinsurance – What's changing?

- Spring Finance Bill 2023 contains two clauses to amend the existing rules with effect from 15 Dec 22
- The first clause addresses a tax mismatch in the life insurance rules where re-insurance precedes a transfer of BLAGAB. In this situation the clause classifies the re-insured business as BLAGAB in the hands of the re-insurer
- This was for the protection of the Exchequer and closes a potential tax gap regarding loss relief and trading profit calculations
- The second clause excludes amounts from the deemed I-E receipt Step adjustment where sums are paid under a re-insurance contract and substantially all the insurance risks relating to a group of policies are re-insured
- This is a welcome narrowing of the rules to be more targeted
- These rules are complicated and worthy of careful consideration if contemplating any reinsurance or reinsurance followed by a transfer of business

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IFRS 17 transition

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Purpose of IFRS 17

IFRS 4 was insufficient because:

- It allowed for the use of local GAAPs to measure insurance contracts
- It provided no single way to account for insurance contracts
- It made it hard for investors to see which groups of insurance contracts were profit-making and which were not

IFRS 4

IFRS 17

IFRS 17 was issued because:

- It increases transparency amongst entities
- It requires entities to measure insurance contracts consistently
- It requires information based on current estimates
- It provides updated information about obligations, performance and risks
- It provides a more appropriate and consistent profit recognition model

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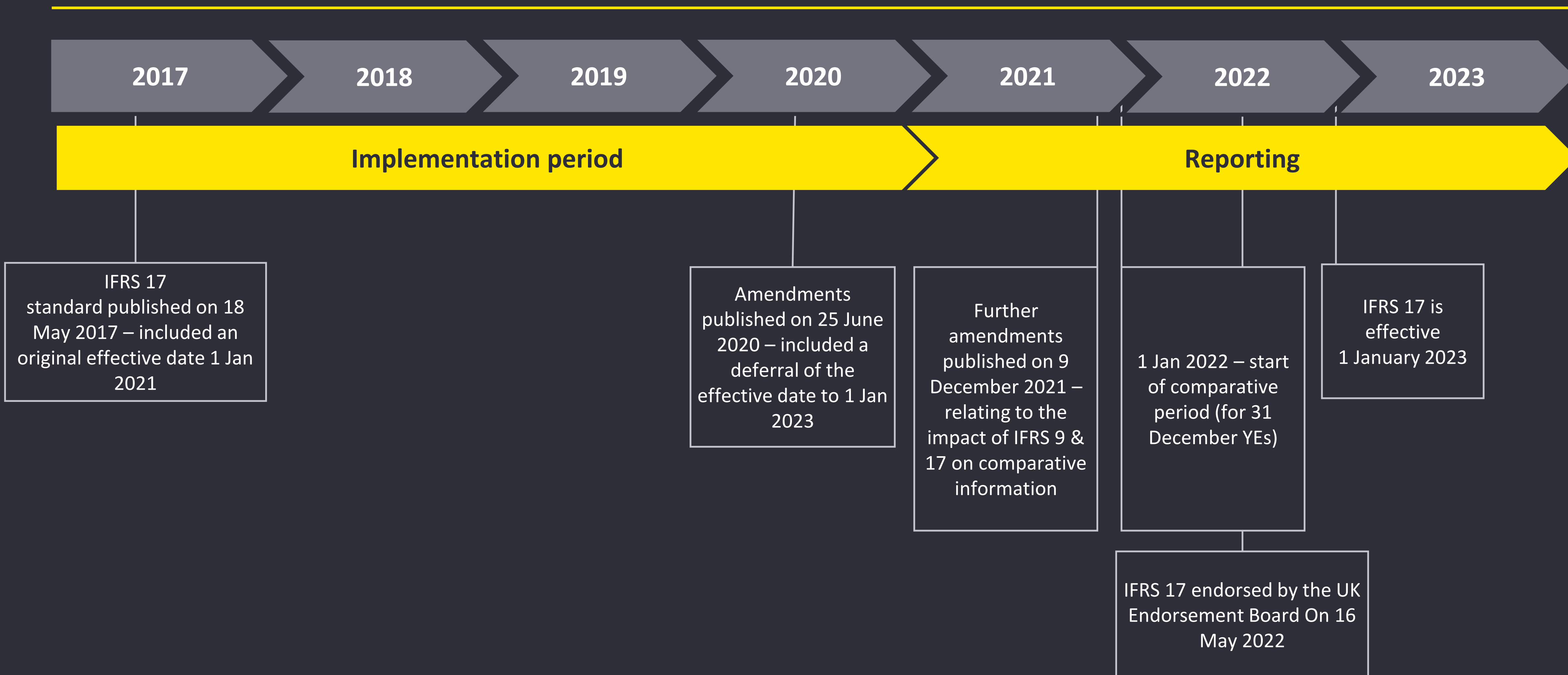
Timeline of implementation



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Balance sheet under IFRS 17

IFRS 4 — Insurance contracts

Assets

Cash and cash equivalents
Assets held for sale
Investments
Derivatives
Reinsurance assets (1)
Deferred expenses
Other assets and receivables
Intangible assets

Liabilities

Insurance contracts (2)
Investment contracts (3)
Derivatives
Borrowings
Provisions
Defined benefit liabilities
Deferred gains
Deferred tax liabilities
Other liabilities

Equity

Shareholders' equity
Other equity instruments

IFRS 17 — Insurance contracts

Assets

Cash and cash equivalents
Assets held for sale
Investments
Derivatives
Reinsurance contract assets (1)
Insurance contract assets (2)
Investment contracts with discretionary participation features (3)
Deferred expenses
Other assets and receivables
Intangible assets

Liabilities

Reinsurance contract liabilities (1)
Insurance contract liabilities (2)
Investment contracts with discretionary participation features (3)
Investment contracts without discretionary participation features
Derivatives
Borrowings
Other liabilities

Equity

Shareholders' equity
Other equity instruments

Entities will be required to disaggregate on the balance sheet 'portfolios' of contracts that are in an asset position from those in a liability position. This disaggregation will need to be performed for insurance contracts issued and reinsurance contracts held.

Acquisition cost cash flows, premiums receivable and unearned premiums are included in the measurement of insurance liabilities. They are no longer presented in the statement of financial position (and related disclosures).

Some insurers may also consider an additional split to differentiate the investment contracts that are measured under IFRS 17 from those that are measured under IFRS 9. Investments contracts with discretionary participation features are under the scope of IFRS 17 if the entity also issues insurance contracts.

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Statement of profit and loss under IFRS 17

IFRS 4 — Insurance contracts

- Premium income (1)
- Investment income (2)
- Fees and commission income
- Other revenues
- Income from reinsurance ceded (3)
- Results from financial transactions
- Other income
- **Total income**
- Premiums paid to reinsurers (3)
- Policyholders' claims and benefits (1)
- Profit sharing and rebates
- Commission and expenses
- Impairment charges/(reversals)
- Interest charges and related fees
- Other charges
- **Total charges**
- **Profit before tax**
- Income tax (expense)/benefit
- **Net income/(loss)**

IFRS 17 — Insurance contracts

- Insurance revenue (1)
- Insurance service expenses
- Allocation of reinsurance premiums (3)
- Amounts recoverable from reinsurers for incurred claims
- **Insurance service result**
- Interest revenue calculated using the effective interest method (2)
- Interest revenue on financial instruments measured at FVPL
- Other investment income
- Results from financial transactions
- Impairment losses/(reversals)
- Insurance finance expenses from insurance contracts issued (New)
- Reinsurance finance income for reinsurance contracts held (New)
- Other financial income
- Interest charges and related fees
- **Net investment result**
- Fee and commission income
- Other income/(charges)
- **Other result**
- **Profit before tax**
- Income tax (expense)/benefit
- **Net income/(loss)**

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Statement of profit and loss under IFRS 17

Insurance revenue
Insurance service expenses
Allocation of reinsurance premiums
Amounts recoverable from reinsurers for incurred claims
Insurance service result
Interest revenue calculated using the effective interest method
Interest revenue on financial instruments measured at FVPL
Other investment income
Results from financial transactions
Impairment losses/(reversals)
Insurance finance expenses from insurance contracts issued
Reinsurance finance income for reinsurance contracts held
Other financial income
Interest charges and related fees
Net investment result
Fee and commission income
Other income/(charges)
Other result
Profit before tax
Income tax (expense)/benefit
Net income/(loss)

Insurance revenue should be comparable with the gross earned premium for P&C. Gross written premium is no longer to be shown on the face of financial statements.

Split of reinsurance premium and recoveries optional.

Insurance service result akin to underwriting result. May be additional volatility due to risk adjustment but expected to have limited impact.

Detail on the contractual service margin under general model is not required for those using the simplified Premium Allocation Approach (PAA).

Economic changes in reserves due to discount rate impacts are separated from cash flow and experience changes (which are taken through insurance service expense). Discounting is only required for a business with a settlement tail of >1 year (which is probably not applicable to most non-life insurers).

Split of expenses between ‘qualifying’ and ‘non-qualifying’ (attributable and non-attributable) will be different from IFRS 4 and across companies.

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IFRS 17 – Summary of tax implications

- For entity level accounts prepared under UK GAAP, there will be no change to the current tax basis. Where group accounts are prepared under IFRS, deferred tax on the UK GAAP to IFRS 17 differences needs to be considered
- For entity accounts prepared under IFRS, current tax will follow IFRS 17 profits for 2023 onwards
- On transition:
  - General insurers – the transitional effect will be taxed/relieved in full in 2023 which is the default position under UK tax law on a change of accounting policy. UK general insurers have typically not expected the move to IFRS 17 to have a significant impact on retained profits so have been content to follow the default position
  - Life insurers – the transitional impact (generally a loss for annuities, profit for WP business) is to be spread over 10 years and taxed/relieved in equal instalments over 2023 to 2032. Providers of annuity business were concerned that they would not be able to absorb the (expected) transitional loss in full in 2023, and carried forward losses would trigger the loss carry forward restrictions which could result in adverse cash tax consequences. Most life insurers concluded that 10 year spreading would allow them to utilise most of the loss as it arose on that 10 year spread basis

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IFRS 17 – Summary of tax implications

- Requirement to restate 2022 comparatives – deferred tax considerations including unwind scheduling of IFRS 17 vs IFRS 4 differences as at 31 December 2021
- IFRS 9 will be adopted at the same time as IFRS 17 for most insurers
- IFRS 9 replaces IAS 39, *Financial Instruments – Recognition and Measurement*, and specifies how an entity should classify and measure financial assets, financial liabilities, and some contracts to buy or sell non-financial items
- Transitional adjustments for IFRS 9 (all entities not just insurers) are to be spread over 10 years – it is important to isolate IFRS 9 impacts from IFRS 17 impacts due to different spreading rules

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IFRS 17 – Charges for tax to policyholders

- Charges are included within policyholder liabilities (above the line) in an attempt to pass the IAS 12 policyholder tax liability onto the underlying policyholders. These above the line charges are proxies calculated as part of the unit pricing process, and are not expected to equal the actual IAS 12 policyholder tax liability levied on the company
- Under IFRS 17, these charges for PH tax are included as a component of Fulfilment Cash Flows (“FCF”)
- There is differences of interpretation across the market in terms of how to estimate (and how to account for) the charges for PH tax under IFRS 17:
  - Whether the charges for PH tax included within unit pricing are calculated on an “I+G” or “I+G-E” basis
  - The geography of where the experience variance (i.e. difference between the cumulative charges for PH tax vs the company’s actual IAS 12 policyholder tax liability
  - Impact of companies in an XSE position
  - Releases from Contractual Service Margin (“CSM”) / Liability for Remaining Coverage (“LRC”)

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HMRC LAM: Friendly Societies Chapter

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HMRC Life Assurance Manual (LAM) – Friendly Societies Chapter

- Following the re-write of insurance tax rules in FA 2012 previously mentioned, a full re-write of the Life Assurance Manual was required
- In May this year, after consultation with industry, HMRC published the updated version of the Friendly Societies chapter – Chapter 17
- This provides helpful guidance for Friendly Societies on HMRC's views on how the legislation should be applied and interpreted
- It makes clear that Friendly Societies, like mutuals, are subject to I-E tax on its BLAGAB business (if it's not Tax Exempt Friendly Society Business which is exempt anyway) and not on a trading profit basis
- It explains the distinction for certain policies that are classified as Tax Exempt Business, giving detail on how the various requirements have changed over the years

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HMRC Life Assurance Manual (LAM) – Friendly Societies Chapter

- The AFM Tax Strategy Committee has made various representations in respect of earlier drafts of the chapter and plans to make further representations in respect of the published document in the near future in respect of various points of detail
- One specific point which is worth drawing out relates to the current premium limit of £270 per annum and how section 155(4)(a) FA12 increases this limit by ignoring 10% of the premium in the test when premiums are paid monthly
- Currently the LAM states:
  - “The principal difference is the specific exemptions from corporation tax for certain categories of business, which since 1995 are limited to business with annual premium limits not exceeding £270, or if paid monthly, £297.”
- I.e. £270 plus 10% of £270 equals £297
- However, the view of the committee is this should be, monthly premium £25 x 12 = £300, ignore 10% (£2.50 or £30) gives £22.50 monthly (i.e. £270 pa)

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Thank you!

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