The UK Budget 2011 – spotlight on insurance

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On March 23, 2011, the Chancellor of the Exchequer announced in the UK Budget a number of measures which will both directly and indirectly affect the UK tax treatment of insurers. Below follows a summary of the relevant changes.

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I. Overview

While the UK insurance sector will no doubt be welcoming the 2 per cent reduction in the main rate of corporation tax in which took effect from April 1, 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 were announced in Budget 2011, which flow from the impending implementation of the European Solvency II Directive ("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. On April 5, 2011, HMRC published a further consultation document, "Life Insurance Companies: A New Corporate Tax Regime"[1] which explores and consults publicly on points of detail arising from the changes to life insurance company taxation announced in the Budget. The consultation period extends until June 28, 2011.

II. Life business

A. Solvency II changes

The advent of Solvency II, expected to be from January 1, 2013, 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.[2]

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

1. Calculation of trade profits

Further to the proposals the government first published on March 10, 2010, the calculation of trading profits for tax purposes of life insurance companies will now be based on the profit before tax reported in the insurance 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). For the purposes of UK GAAP, 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. For life insurers adopting IFRS, the computational starting point will be profit before tax expense, adjusted for any credits or debits for tax on income or profits included in the income statement which affect the disclosed profit before tax.[3]

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.[4] 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 Phase II of IFRS 4 (Insurance Contracts) will have on this position.[5]

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".[6]

2. Taxation of assets

At the time of writing, 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 therefore considering basing the taxation of insurance companies' assets on the fixed or circulating nature of the capital, based on first principles. While the current distinction between assets held outside the long term insurance fund as shareholders assets, and assets within the long term insurance fund, is specified in the constitution of some life insurers, it is considered by HMRC that such a constitutional distinction is not, by itself, sufficient justification for the retention of a basis of taxation where Solvency II does not recognise that distinction. 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.

3. Transitional rules

Transitional rules will be introduced to smooth the effect of moving to a more accounts-based approach. HMRC have recognised that the change to an accounts-based regime may result in taxing amounts which would have been deferred under current rules. The intention of the transitional provisions is stated as being to "ease the transitional impacts on a basis which is simple and consistent between companies"[7] and to avoid double taxation. Deferred acquisition costs[8] will not be relieved on an accounting basis following transition where they have already been written off in the current regulatory returns in order to avoid double relief. Conversely, deferred income reserves[9] 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,[10] 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 prohibition on distribution of these amounts, the transitional taxation will be deferred for two years or until the date of removal of the prohibition (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 ten 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 which are unused at the transition date will be available for carry forward into the I-E computation under the new regime and a proportion of BLAGAB life assurance trade losses which are unused at the transition date will be available for carry forward against BLAGAB trade profits for the purposes of the new "minimum profits test".[11]

B. 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 "protection" life assurance policies which provide no separate investment element in addition to life cover and will have effect from January 1, 2013 in relation to such policies written after that date. Further consultation is expected as to how "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 resulting in the I-E basis applying to BLAGAB business only 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.

C. 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 rollup business and permanent health insurance. However, with gross roll-up business being excluded from the I-E basis of computation with effect from 2013, the measure of profits from both permanent health insurance and gross roll-up business will be the accounting profit (in each case) from that year. Accordingly, these categories of long term business will form part of a category taxed on the basis of trading profits, with only BLAGAB continuing to be dealt with separately.

D. 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. These changes are intended to bring the treatment of life insurance transfers into line with the transfer of general insurance business.

E. Apportionment rules

Changes to the rules for the apportionment of income and gains between different categories of long term business were announced in the Budget and have now been introduced as clause 56 of Finance Bill 2011. These changes are part of the Government's stated intention to simplify the existing rules, to eliminate current anomalies (hence the Finance Bill 2011 changes) and to "bring tax apportionments more in line with the commercial reality".[12] HMRC appears to be very well aware that the methods of apportionment may differ between life insurers, and therefore has extended a welcome offer of agreements with HMRC customer relationship managers to achieve certainty as to what an appropriate approach to tax apportionment would be in each case . Further consultation is expected in this area.

F. 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).

G. Mutuals

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

III. Non-life business

A. 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[13]. 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.

B. 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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NOTES

[1] Available at : http://customs.hmrc.gov.uk/channelsPortalWebApp/channelsPortalWebApp.portal?_nfpb=true&_pageLabel=pageLibrary_ConsultationDocuments&propertyType=document&columns=1&id=HMCE_PROD1_031

[2] empty footnote

[3] 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).

[4] 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.

[5] The IASB is currently considering the responses to the exposure draft of IFRS 4 following publication of the exposure draft last year. The final form of IFRS 4 is therefore unclear at the present time, as is the date at which any final standard will have effect.

[6] Paragraph 1.8 "Solvency II and the Taxation of Insurance Companies" , HMRC Technical Note, 23 March 2011.

[7] Paragraph 3.2, "Solvency II and the Taxation of Insurance Companies" , HMRC Technical Note, 23 March 2011.

[8] I.e. the costs for a life insurance company of securing new business (such as commissions to financial advisers) which are spread over a number of years in the accounts of the company.

[9] 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.

[10] As a result of a need to balance the interests of shareholders with the interests of with-profits policyholders.

[11] It is not yet clear how this proportion will be calculated.

[12] Paragraph 2.8, "Solvency II and the Taxation of Insurance Companies" , HMRC Technical Note, 23 March 2011.

[13] Paragraph 6.3, "Solvency II and the Taxation of Insurance Companies" , HMRC Technical Note, 23 March 2011.

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