CLIFFORD CHANCE

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Solvency II – UK tax implications

General

The advent of Solvency II has resulted in detailed discussions between the UK's HM Treasury ("HMT"), HM Revenue and Customs ("HMRC") and insurance industry (both general and life) as to what it means for the tax treatment of insurance companies. At a policy level, it provides an opportunity to try to simplify insurance company tax and bring it into line with the taxation of other UK businesses. In March 2010, a Consultation Document was issued jointly by HMT and HMRC to highlight the implications of the move to the new regulatory regime and what it might mean in tax terms. In addition to considering the changes needed because of the implications of the Directive, the UK Government also indicated that it wanted to start discussions on a much wider ranging reform of the life insurance taxation regime (including the possibility of an alternative to I-E).

The publication of that Consultative Document marked the beginning of an extensive consultation between the Government and the insurance industry, with HMT and HMRC hosting an Open Day in July 2010 to update the industry on the results of the consultation and indicate current HMRC progress on the various issues raised. At that Open Day it was confirmed that discussions on a wider reform of I-E would be deferred, even though reform remains a long-term strategic objective of the Government.

Life insurance companies

With any required legislative changes needing to be included in the Finance Bill 2012 (so they can be enacted prior to Solvency II becoming effective on 1 January 2013), the need to start focussing on the detail is becoming urgent. As a result, this week's Budget marks the next step in this process, with the publication of a Technical Note outlining a new life insurance tax regime which would take effect from 1 January 2013.

The Technical Note offers an overview of the decisions made by the Government as to the changes that are needed. It will be closely followed by a further Consultation Document (to be issued in April), which will explore how these decisions are to be implemented. This will then be the subject of further detailed discussions with insurance businesses with a view to finalising draft legislation ready for inclusion in Finance Bill 2012.

The intention underlying the proposals in the Technical Note is to create a simpler and more stable tax basis that is more consistent with the taxation of companies generally. "Simplification" is a consistent theme throughout the Technical Note.

In terms of key points to note from the Technical Note in relation to life insurance companies:

- The starting point for the calculation of a life insurance company's trading profits under Solvency II will be the insurance company's statutory accounts
- There will be no special tax rules to govern the treatment of Funds for Future Appropriations or Unallocated Divisible Surpluses

Key Issues

UK Government publishes Technical Note on insurance company taxation post Solvency II on Budget day

Focus of Technical Note is on "simplification" of insurance tax rules

Further consultation with industry to follow, with legislation planned for 2012

Other Budget changes include allowing (some) life insurance business to benefit from proposed exemption from UK tax on foreign branches of UK companies

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- A tax deduction will in principle be available for tax borne on behalf of policy holders, with the Government intending to consult on the measure of that deduction. The aim is that the deduction should be calculated in a way which is simple and transparent
- From 1 January 2013, only Basic Life Assurance and General Annuity Business ("BLAGAB") will be covered by I-E: gross roll up business will be excluded. The minimum profit test (to compare the I-E computation with trading profits) will apply solely to BLAGAB from then. There will be a consultation on the implications of I-E volatility, with a stated willingness to consider options for ameliorating its effects
- Simplification of the taxation of long-term business is proposed by reducing the number of categories of business to two – BLAGAB and a new category to be taxed on a trading profits basis (which will include the "old" categories of Gross Roll Up Business and Permanent Health Insurance). Protection business will cease to exist as a separate business and policies written from 1 January 2013 will fall within the new category of business taxed on a trading profits basis
- There is a stated aim of simplifying the manner in which income and gains are apportioned between businesses – with an emphasis on applying a factual commercial basis, that can be discussed and agreed between the insurance company and its inspector. This again is to be subject to consultation
- The distinction between shareholder fund assets and long term insurance fund assets will no longer remain: instead there will be a distinction between fixed and circulating capital, established on first principles. It is intended that detailed guidance will be drawn up by HMRC, working closely with the industry, as to how this will operate in practice
- No changes are proposed to the tax treatment of mutual businesses
- The rules for the transfer of business will be simplified with the focus, for transfers between unconnected persons, being on following accounting principles. For transfers between connected persons, changes are proposed to bring the treatment in line with that which applies to general insurance. An anti-avoidance rule will continue to apply
- Transitional adjustments will need to be provided for, and this will be the subject of consultation. Three categories of transitional timing adjustments have been identified – Deferred Acquisition Costs and Deferred Income Reserves; Untaxed Surpluses within Court Schemes; and Residual Transactional Adjustments. It is acknowledged that other adjustments may be needed
- It is intended that existing tax losses can be carried forward against "new" regime profits (although for BLAGAB, only a proportion of trade losses will be so available and then only for the purposes of applying the minimum profits test; excess BLAGAB expenses will, however, be available for carry forward into the new regime's I-E computations).

It is clear from the Technical Note that many areas of detail remain outstanding and will, therefore, be the subject of discussion between HMRC and the insurance industry over the coming months. Further, possible future changes to International Accounting Standards in relation to insurance contracts may require yet more changes to be made in the future. It is clear, however, that the Government have valued the input from the industry to date and are looking to continue working closely with the industry over the coming months to finalise the legislative changes needed.

General insurance

Although the focus of the Technical Note is on the life sector, reference is also made to the implications of Solvency II on general insurance companies in relation to claims equalisation reserves (CERs).

The regulatory requirement to maintain CERs will fall away with Solvency II. As a result, tax effective reserves will be released. Two options are identified – either, continuing the tax relief for CERs, or, providing for the reserves to be released over a 6 year transitional period if the relief is to be discontinued.

The Government intends to consult on the tax implications of such reserves post Solvency II – in particular, it is inviting the industry to make representations as to the continuation of such tax relief. More specifically, the industry has been asked to provide a "robust justification" for such relief continuing. Informal consultation will commence in April 2011, again with a view to any legislation being within Finance Bill 2012.

Conclusion

Any moves to simplify the taxation of the insurance sector will remove some of the opacity of insurance company accounts. This may have the consequence of making the industry more accessible, with potential for a wider interest in the sector from investors, as well as easing access to funding. The industry should be encouraged to continue to participate fully in the various consultations and thereby help shape the resulting tax provisions.

Other matters of interest from the UK Budget

- Corporate tax rates: The Government have slightly accelerated the timetable for the staggered reduction in the rate of corporation tax. The main rate will now be reduced by two percentage points from 28 per cent to 26 per cent from next month, falling 1 per cent over the next 3 years resulting in a 23 per cent rate by April 2014; however, the Finance Bill 2011 will only legislate a rate of 26 per cent. from April 2011 and 25 per cent. from April 2012.
- REITs consultation: Likely to be of particular interest to the insurance industry is the HMRC announcement that it will consult on possible changes to the REIT regime to encourage new entrants, with a focus on removing perceived barriers to entry. In particular, one issue on which comments are sought relates to making changes to facilitate the setting up of REITs by institutional investors (who would, for example, maintain a "seed" interest in the REIT) by introducing a diverse ownership rule for such investors to allow the non-close company condition (which is intended to ensure REITs are widely held) to be met. The consultation will commence in April 2011 with a view to legislation in Finance Bill 2012.
- Controlled Foreign Company reform: Full reform of the CFC rules is due by Finance Act 2012 and the consultation is continuing. The general direction of travel is that it is intended that the new CFC rules will apply a 'lighter touch' with a more territorial approach, catching only income artificially diverted from the UK.
- Branch Exemption: As previously announced, Finance Bill 2011 will introduce an exemption from UK corporation tax for foreign branches of UK companies. Draft legislation was published on 9 December 2010 and a number of changes to this draft legislation were announced in the Budget following comments and concerns raised as part of the consultation. These include elements of the anti-diversion rules, transitional rules and capital allowances. In addition some life insurance business will now be eligible for exemption.
- Stop loss and quota share insurance: The Government will consult with the industry on proposals to amend the timing of the tax deduction for Lloyd’s member-level stop-loss premiums following a recent change in its view (which will be reflected in changes to be made in published HMRC guidance). Legislation will be included in Finance Bill 2012.