

LIFE FINANCIAL REPORTING SUB-COMMITTEE

Discussion Note: The impact of Tax Reform on the Determination of Solvency and Capital Adequacy Requirements

1 BACKGROUND

Major changes to the basis of taxation of life insurance companies operating in Australia were made in 2000. In broad terms, the changes resulted in life companies paying tax, at the corporate rate, on their profits.

These tax changes have implications for life companies' best estimate liabilities, policy liabilities and embedded values. They also have implications for the determination of life companies' Solvency and Capital Adequacy Requirements.

The purpose of this note is to discuss these capital implications and consider what account of tax should be taken in calculating the Solvency and Capital Adequacy Requirements under the new tax rules.

2 ACCEPTED PRACTICE UNDER THE OLD TAX BASIS

When calculating the Solvency and Capital Adequacy Requirements pre the 2000 tax changes, tax relief was generally allowed for in the following areas:

- Resilience Reserve (Capital Adequacy and Solvency) – the deferred tax reserve would generally be significantly different if calculated on the asset values provided under the resilience scenarios. It was appropriate to allow for the change in the deferred income tax liability (increase or reduction as appropriate) when calculating the resilience reserve (consistent with Section 12.9.3 of AS2.02 and Section 12.10.3 of AS3.02).
- Maintenance Expenses in Liability Calculation (Capital Adequacy and Solvency) – under the old tax basis a tax deduction was available for maintenance expenses on savings business. It was appropriate to allow for this in the Solvency Liability and Capital Adequacy Liability calculation.

3 CALCULATING THE ALLOWANCE FOR TAX UNDER THE NEW TAX BASIS

Under the new tax basis most life insurance companies will have access to tax relief in a wider range of circumstances. Where the value of tax losses is taken into account in determining the Solvency Reserve / Capital Adequacy Reserve, particular caution should be taken to ensure that there is sufficient taxable income

to realise the value of these tax losses, and to do this in a way consistent with the principles set out in the Standards.

The process of determining the Solvency / Capital Adequacy Reserve involves a calculation process with several steps.

The Standards provide guidance on how allowance should be made for tax at each step. The actuary should also consider how assumptions in earlier steps impact the allowance for tax in subsequent calculations.

This note considers some of the issues regarding tax that should be considered when determining the Solvency / Capital Adequacy Requirement under the Standards.

4 SOLVENCY

The purpose of the Solvency Requirement is to ensure that each statutory fund of a life company will be able to meet its obligations to policy owners and other creditors. In particular the Solvency test is that the statutory fund would be able to meet its obligations in a run-off scenario.

This objective of AS2.02 should be taken into account when assessing the impact of tax on the Solvency Requirement.

4.1 Solvency Liability Calculation

The Solvency Liability is a calculation of the value of the liabilities using assumptions that are more conservative than best estimate. AS2.02 addresses the assumption of tax on investment earnings in Section 4.4.1. Allowance for tax on investment earnings must be made in accordance with best estimate assumptions, but based on the asset distribution underlying the Solvency Assumption for gross investment earnings.

Section 4.4.1 of AS2.02 states that allowance for tax on other than investment items must be made in accordance with Best Estimate Assumptions.

For many products shareholders are now taxed on profits rather than on an investment income less expenses basis. The allowance for tax on other than investment income may therefore include consideration of the availability of tax relief due to:

- Losses envisaged under AS2.02 due to adverse Solvency assumption changes that require transfers into the SEA / VPST will generate tax deductions.

- Changes in policy liabilities and experience losses for non-participating risk business will also generate tax deductions, although changes in policy liabilities will be matched by an offsetting change in accumulated losses which are included in tax reserves. The tax loss therefore emerges over time as experience losses occur / the accumulated loss is run down.

As quoted from AS2.02 above, tax relief on these tax losses may be allowed in accordance with best estimate assumptions. The actuary should consider whether there is sufficient taxable income to realise the value of tax losses. Taxable income may include:

- Profit streams from profitable business (including MoS profits on risk business and immediate annuities, fees less expenses on investment-linked business), although on solvency / capital adequacy assumptions.
- Taxable income from investment returns in Ordinary tax class (investment income and the realisation of capital gains) – including policy owner assets to the extent these are accessible as an offset against these tax losses.

The actuary should be aware of the rules regarding carrying forward of tax losses and restrictions on transferring income between tax classes. For example, as the tax law currently stands, taxable income in the VPST cannot be applied to realise the value of shareholder tax losses.

4.2 Minimum Termination Value Calculation (MTV)

Where the MTV is the amount paid on voluntary termination AS2.02 would appear **not** to allow any tax relief that might emerge due to tax losses on policy surrender.

Where the policy benefit is not fully paid out at the time of termination, Section 9.3.2 requires the MTV be calculated as the present value of future payments using assumptions consistent with AS2.02. “Assumptions consistent with this Standard” would include assumptions for future tax relief that would arise in the scenario in which the adverse projected experience occurred.

In effect, the excess of the gross-of-tax value of benefits over the gross-of-tax best estimate liability can be netted down for tax.

4.3 Expense Reserve

The basis for this reserve is that on ceasing to write new business there may be an overrun of acquisition expenses. Allowance for the tax deductions from the expense overrun envisaged is permitted, however, allowance should only be made

where income is expected in the next financial year sufficient to justify that deduction (refer to the “Please Note” points after Section 10.6 of AS2.02).

Care should be taken to ensure assessable income is not double counted in securing the value of tax losses. For example, income used to secure tax relief for the expense reserve should not be included when determining the value of tax losses in the Solvency Liability or Minimum Termination Value calculation.

4.4 Minimum of Current Termination Value (CTV)

The statutory fund is not considered solvent unless the Termination Basis currently in use is secured.

The CTV is defined in Section 10 of AS3.02. Similar considerations as set out in Section 4.2 above for MTVs apply for the CTV calculation.

4.5 Resilience Reserve

The deferred tax reserve on unrealised gains typically changes significantly when calculated using the asset values provided under the resilience scenarios. This movement in the deferred tax reserve is allowed for when calculating the Resilience Reserve consistent with Section 12.9.3 of AS2.02.

The change to tax on profits rather than on investment income less expenses means that the impact of the reduction in policy liabilities and CTV / MTV on the tax payable may also need to be taken into account when calculating the Resilience Reserve.

Some life companies may make allowance for a Future Income Tax Benefit (FITB) that might arise in respect of unrealised losses. For Solvency purposes, the actuary would need to be satisfied that the FITB would be admissible, as required by Section 11.2.2(d) of AS2.02. The value of the future income tax benefit due to the company should not exceed the benefit that would be realised on ceasing business.

In addition, sources of taxable income should not be double counted when examining the ability to realise the value of tax losses. When determining the Resilience Reserve and making allowance for the reduction in deferred tax liabilities on unrealised gains on ordinary assets, the gains should not be counted to the extent they had already been applied in realising the value of tax losses in the Solvency Liability and Minimum Termination Value calculation (pre resilience), and in the calculation of the Expense Reserve.

5 CAPITAL ADEQUACY CALCULATION

The purpose of the Capital Adequacy Requirement is to ensure a company is able to maintain solvency while conducting its business in an unfettered manner over the next 3 years.

5.1 Capital Adequacy Liability Calculation

The Capital Adequacy Liability is a calculation of the value of the liabilities using assumptions that are more conservative than best estimate. AS3.02 addresses the assumption of tax on investment earnings in Section 4.1.4. Allowance for tax on investment earnings must be appropriate to the Capital Adequacy Assumption for gross investment earnings.

For assumptions other than investment earnings, the guidance from AS3.02 on the allowance for tax is not as clear. However, Section 9.1 states that the Capital Adequacy Liability should be determined using the same methods used for the Best Estimate Liability calculation but adopting Capital Adequacy Assumptions.

For many products shareholders are now taxed on profits rather than on an investment income less expenses basis. The allowance for tax on other than investment income may therefore include consideration of the availability of tax relief due to:

- Losses envisaged under AS3.02 due to adverse Capital Adequacy assumption changes that require transfers into the SEA / VPST will generate tax deductions.
- Changes in policy liabilities and experience losses for non-participating risk business will also generate tax deductions, although changes in policy liabilities will be matched by an equal but opposite change in accumulated losses which are included in tax reserves. The tax loss therefore emerges over time as experience losses occur / the accumulated loss is run down.

Tax relief on these tax losses should be determined using the methods used to determine the Best Estimate Liability but adopting Capital Adequacy Assumptions. In making allowance for tax relief the actuary will need to consider whether there is sufficient taxable income to realise the value of tax losses. Taxable income may include:

- Profit streams from profitable business (including MoS profits on risk business and immediate annuities, fees less expenses on investment-linked business), although on solvency / capital adequacy assumptions.
- Taxable income from investment returns in Ordinary tax class (investment income and the realisation of capital gains) – including

policy owner assets to the extent these are accessible as an offset against these tax losses.

The actuary should be aware of the rules regarding carrying forward of tax losses and restrictions on transferring income between tax classes. For example, as the tax law currently stands, taxable income in the VPST cannot be applied to realise the value of shareholder tax losses.

5.2 Current Termination Values

A company is not considered capital adequate if it cannot secure the total Termination Value on the current basis.

The CTV is defined in Section 10 of AS3.02. Similar considerations as set out in Section 4.1 above for MTVs apply for the CTV calculation.

5.3 Resilience Reserve

The deferred tax reserve would generally be significantly different if calculated on the asset values provided under the resilience scenarios. This is allowed for when calculating the Resilience Reserve consistent with Section 12.10.3 of AS3.02.

The change to tax on profits rather than on investment income less expenses means that the impact of the reduction in policy liabilities and CTV / MTV on the tax payable may also need to be taken into account when calculating the Resilience Reserve.

Some life companies may make allowance for a Future Income Tax Benefit (FITB) that might arise in respect of unrealised losses. For Capital Adequacy purposes, the actuary would need to be satisfied that the FITB would be admissible, as required by Section 11.2.2(d) of AS3.02. The value of the future income tax benefit due to the company should not exceed the benefit that would be realised on ceasing business.

In addition, sources of taxable income should not be double counted when examining the ability to realise the value of tax losses. When determining the Resilience Reserve and making allowance for the reduction in deferred tax liabilities on unrealised gains on ordinary assets, the gains should not be counted to the extent they had already been applied in realising the value of tax losses in the Capital Adequacy Liability and Minimum Termination Value calculation (pre resilience).

5.4 New Business Reserve

The New Business Reserve is the amount required to fund the Solvency Requirement of the statutory fund will continue to be met over the following 3 years

under the companies business plans, less an allowance for capital that may be available from sources outside the statutory fund.

Section 4 sets out some of the tax issues that should be considered when forecasting the Solvency Requirement over the next 3 years.

6 OTHER ISSUES THAT HAVE EMERGED

Tax Rates – the tax rate on shareholder income is now at the corporate rate rather than a rate based on the class of business in the statutory fund. This is likely to increase the value of tax relief on the expense reserve – for example for annuity business.

It is important to note that while the tax base has been expanded to include sources of revenue that were previously not taxed, or taxed at a lower rate, losses outside the VPST will be quarantined against income in the VPST (including investment income) thus reducing the availability of income against which deductions can be made.

Realising assets immediately to get the tax relief may reduce the value of the net assets if the deferred tax provision has been calculated on a discounted basis.

7 CONCLUSIONS

The key principles in the Standards for assessing the likely magnitude of this taxable income are as follows:

- For the Solvency Requirement the Standard requires in Section 11.2.2 (d) that “the value of a future income tax benefit (FITB) must not exceed the value of any income tax benefit that would accrue and be realised on ceasing business.” Under a strict interpretation of the Standard this rule might only be seen to apply to the current FITB, rather than to FITB that might arise after applying the tests in the Standard. However, it would seem reasonable to apply a similar test to any FITB that might be expected to arise **after** applying the assumptions in AS2.02.
- The Capital Adequacy Requirement provides less guidance on the assessments an actuary should make in determining the extent to which any tax losses should be excluded. We suggest that a reasonable approach is to anticipate taxable income **not** exceeding the amount that would be reasonably likely to emerge on continuing business under the scenarios envisaged in AS3.02.

A further important point is to note that transitional provisions will reduce the availability of taxable income.

In order to evaluate the extent to which tax relief should be taken into account the actuary may have to go to significantly greater effort to understand the future tax position under the scenarios envisaged under the Standards. The extent to which additional work is required will depend largely on individual company circumstances.