



Briefing

Insurance and reinsurance news

Update on proposed changes to the UK taxation of insurance groups

Summary

HM Treasury (HMT) has been consulting on substantial UK tax law changes to be introduced in 2013 in two areas relevant to insurance groups. The first is the taxation of controlled foreign companies (CFCs). The existing CFC regime has been blamed for several UK-headquartered insurance groups leaving the UK. HMT hopes that changes to the system will reverse this trend and encourage groups to relocate their headquarters to the UK, as Aon has recently done. The second is the taxation of life assurance business. The current tax system relies on regulatory returns, which following the implementation of Solvency II will not provide the necessary information. The current life tax system must therefore be overhauled.

In December 2011 and on 31 January 2012 further papers and draft legislation were published in respect of these two topics. Consultation is ongoing and therefore this newsletter summarises key points, rather than describing the detail of the draft legislation.

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CFCs

Under the CFC rules a UK company can be assessed to UK tax on profits realised by a non-UK tax resident company that it controls. The aim of the rules is to prevent the diversion of income from the UK to lower tax jurisdictions. There are exemptions, including for CFCs carrying on exempt activities as defined. One problem for insurance groups has been that intra-group insurance and investment business are treated unfavourably in the exempt activities exemption so it will not always apply, and it will certainly not apply to intra-group reinsurers. For similar reasons, exclusions added in 2011 are also unlikely to be helpful to insurance groups.

It is worth noting that the rules as presented in the 31 January 2012 draft legislation would make it practically easier for groups to redomicile to avoid the CFC rules, making it even more important from HMT's perspective to get the scope of the rules right.

Key points for insurance groups are listed below.

- The commencement of the rules will be aligned with commencement of the new life tax rules described below.
 - An exemption for CFCs based in 'excluded countries' will remain, but will not apply in the case of Luxembourg where the company is an insurer.
 - Property income will be excluded from the rules. This will be helpful to insurance groups holding property to back liabilities, particularly when local investment companies are used to hold that property.
 - In determining whether a company is a CFC, some regard is likely to be had to where the significant people functions (SPFs) relevant to asset ownership or management of risk are (ie, the CFC rules would apply if the SPFs were in the UK). The concept of SPFs is used in the Organisation for Economic Co-operation and Development commentary on profit attribution and transfer pricing. This is a test that is more likely to be appropriate for insurers than one focused on headcount (something the Association of British Insurers – ABI – was concerned about), but will still not help overseas insurers using UK persons to insure non-UK risk.
- There may be an exemption when only a small proportion of the CFC's trading income is derived from the UK. The ABI was concerned to ensure a level playing field between insurers focusing on UK business and those focusing on global business and this should help.
 - The following types of income are likely to be within the CFC regime:
 - income from financial investments, but only if UK-connected. It is good news for insurers that the mere existence of investment income does not lead to a CFC charge, but the proposed UK connection definition would require groups to consider how non-UK entities are funded;
 - trading profits derived from shares and securities (potentially with an exclusion for certain types of insurance business), but only to the extent that the CFC is over-capitalised. For insurers the capitalisation test examines both asset surplus and free capital, by reference to the company's actual position, rather than by reference to minimum regulatory capital requirements. But a safe harbour is also proposed where capital is between 200 and 250 per cent of minimum regulatory capital; and
 - in the case of a non-European Economic Area (EEA) CFC, income from intra-group reinsurance if the underlying insurance contract is with a UK group entity. Therefore, reinsurance with a UK cedent will not be caught if the underlying risk is non-UK, or third party. In the case of an EEA insurer, reinsurance income is exempt unless there are no commercial reasons for the reinsurance. This is a significant relaxation of the current rules and is clearly in response to ABI representations that intra-group reinsurance should not always be viewed as diverting profits from the UK.

- In respect of CFCs otherwise caught by the rules, an elective partial exemption is proposed (mainly aimed at finance companies) that has the effect of taxing intra-group finance profits at an effective tax rate of 5.75 per cent (by 2014) or exempting some profits entirely. Contrary to previous indications, HMT now proposes that insurance groups will be able to use this election, but not when either the loan is funded by, or is a loan to, a UK insurer.
- The tax regime applying to life assurance companies will be more similar to that applying to companies in general. For the most part the 'normal' rules in relation to the taxation of debt, derivative contracts and intangible assets will apply to life insurers. In addition, whereas the distinction between capital assets and trading assets is currently determined largely by reference to whether an asset is held in the long-term fund or the shareholder fund for regulatory purposes, in the future it will be necessary to consider case law principles of more general application in determining whether an asset forms part of the trade, or is a capital investment for the benefit of the shareholders.

Life taxation under Solvency II

As well as addressing Solvency II, the new life tax regime should amount to a simplification. Some of the key features of the new tax regime are listed below.

- Currently both basic life assurance and general annuity business – BLAGAB – (including protection business) and gross-roll-up business are taxed on the I minus E basis, using the regulatory returns as the basis for taxation. Permanent health insurance (PHI) is taxed on an accounts basis. Complex statutory formulae apply to allocate profits, income and gains between different lines of business.
- Under the new system BLAGAB (excluding protection business) will be taxed on the I minus E basis, but using the accounts as the basis. All other business (old gross-roll-up business, protection business and PHI) will be taxed on an accounts basis. The allocation of profits between businesses will be a commercial allocation rather than one prescribed by statute. Removing protection business from the I minus E computation is expected to impact the I minus E profile of certain insurers.
- In relation to transfers of long-term business, it is proposed that:
 - transfers between connected companies should result in the transferee standing in the shoes of the transferor for tax purposes, so that (absent asymmetry in treatment by the parties) no profits or losses should arise; and
 - when on a transfer of business from an unconnected company, the transferee recognises an amount in respect of PVIF (present value of in force business) any amortisation of this amount would be deductible for tax purposes.

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