Subject SA2

CMP Upgrade 2022/23

CMP Upgrade

This CMP Upgrade lists the changes to the Syllabus, Core Reading and the ActEd material since last year that might realistically affect your chance of success in the exam. It is produced so that you can manually amend your 2022 CMP to make it suitable for study for the 2023 exams. It includes replacement pages and additional pages where appropriate.

Alternatively, you can buy a full set of up-to-date Course Notes / CMP at a significantly reduced price if you have previously bought the full-price Course Notes / CMP in this subject. Please see our 2023 *Student Brochure* for more details.

We only accept the current version of assignments for marking, *ie* those published for the sessions leading to the 2023 exams. If you wish to submit your script for marking but only have an old version, then you can order the current assignments free of charge if you have purchased the same assignments in the same subject in a previous year, and have purchased marking for the 2023 session.

This CMP Upgrade contains:

- all significant changes to the Syllabus and Core Reading
- additional changes to the ActEd Course Notes and Assignments that will make them suitable for study for the 2023 exams.

1 Changes to the Syllabus

This section contains all the ***non-trivial*** changes to the Syllabus objectives.

Objective 2.2 has been amended to the following:

2.2 Explain the general principles of the taxation of life insurance business from the perspective of:

- governments
- policyholders
- life insurance companies.

2 Changes to the Core Reading

This section contains all the ***non-trivial*** changes to the Core Reading.

Throughout the course:

- references to 'his or her' have been amended to 'their'
- dates have been moved forward from May 2021 to May 2022.

Chapter 1

Section 2.1

The first sentence of the third Core Reading paragraph has been amended to:

The aim of an IP product is to replace part of the income that the insured would have earned if they became unable to work due to accident, mental health condition or illness.

Chapter 3

Section 1.3

The Core Reading paragraph starting 'The risks faced by the insurer …' has been amended slightly and now reads as follows:

The risks faced by the insurer under accumulating with-profits business can be similar, in principle, to those for conventional with-profits in terms of policy guarantees, investment performance, expenses, tax, adverse publicity and depletion of capital or free reserves.

Chapter 4

New Section 1.12

New material has been added on mental health, for which replacement pages are provided.

Section 4.3

The following new Core Reading paragraphs on closed funds have been added:

Some jurisdictions have seen an increase in life insurance consolidation specialists that acquire closed funds of business from other insurance companies. These consolidation specialists will look to efficiently run off these closed funds in a profitable way.

There are risks for the consolidation specialists with respect to integrating closed funds into their own business.

The companies that dispose of their legacy closed books of business can potentially release trapped capital that could be used more profitably elsewhere.

Chapter 5

Section 2.1

The second bullet point in the list on page 4 has been amended to:

- **disability (which may also cover mental health conditions)**

Section 2.2

The first two bullet points on page 5 have been amended to:

- **they have a physical or mental health condition, and**
- **the condition has a substantial and long-term adverse effect on their ability to carry out normal day-to-day activities.**

Chapters 6 and 7

The Taxation chapters have been rewritten for 2023 Examinations, replacement pages are provided.

As there are now only two chapters on Taxation, the subsequent chapters have been renumbered.

Chapter 8 (previously Chapter 9)

Section 4

There have been several amendments to this section and therefore replacement pages have been provided.

Section 7.1

The second Core Reading paragraph has been amended slightly to:

An example that is specifically related to the UK is that the Institute and Faculty of Actuaries has issued specific professional guidance that applies to members who are appointed as, or who provide support to, Chief Actuaries, Small Insurer Chief Actuaries, With-Profits Actuaries, Appropriate Actuaries and Reviewing Actuaries, appointed by or in respect of UK authorised insurance companies and friendly societies writing long-term insurance business.

Section 8.4

The final paragraph at the bottom of page 26 has been shortened to:

APRA is funded largely by the industries that it supervises. It was established on 1 July 1998.

Chapter 9 (previously Chapter 10)

Section 4.3

The Core Reading paragraphs on the With-Profits Actuary and Appropriate Actuary at the end of the section have been deleted.

Section 5.3

The final sentence of the Core Reading paragraph at the start of page 18 has been deleted, along with the subsequent sentence starting 'As of 31 January …'.

Section 5.4

The second Core Reading paragraph in this section has been amended slightly to read:

Whilst the Chinese banking and insurance regulator (the CBIRC) aimed to make C-ROSS comparable to international standards, it also wished to reflect the characteristics of the Chinese insurance market, with particular recognition that this insurance market is still relatively young in comparison to those in the USA and Europe.

The reference to the FSB website on page 24 has been removed.

Chapter 10 (previously Chapter 11)

Section 3.2

The reference to 'Allowing for tax' chapter has been removed from the penultimate Core Reading paragraph on page 23.

Chapter 11 (previously Chapter 12)

Section 2.1

The last paragraph has been amended to refer to the 'Standards' section as opposed to the 'Upholdings Standards' section of the IFoA website.

Section 2.5

There have been some updates to this section. Replacement pages are provided.

Chapter 12 (previously Chapter 13)

Section 5

The following has been added below the fifth bullet point within the Core Reading list:

- **whether a policy or any change in process / terms treats vulnerable customers, customers with a mental health problem, or disabled customers fairly**

Chapter 21 (previously Chapter 22)

Section 8.1

This Introduction section has been removed.

Chapter 22 (previously Chapter 23)

Section 1.4

A new section has been inserted after Section 1.3 and reads as follows:

1.4 Barriers for consumers

Care is needed during the design of life insurance products to ensure that barriers for consumers are removed or minimised.

An example could include removing barriers for consumers with mental health conditions, such as:

- **signposting customers to alternative options (eg specialist brokers) and/or support services if cover has been declined**
- **training claims staff to identify vulnerable customers, dealing with these customers compassionately and identifying support services if required**

  One of the UK's regulators (the FCA) has published guidance on the fair treatment of vulnerable customers, with the aim to ensure that insurers embed the right culture to achieve consistency of outcomes for such customers.

  Examples of processes that can be used in dealing with vulnerable customers include providing a choice of communication channels, removing target times for phone calls, and tailoring information provided.
- **identifying and changing areas of the underwriting process that may cause anxiety**
- **bundling a product with support services for mild mental health symptoms and conditions**
- **providing rehabilitation services where appropriate (eg for income protection products).**

Chapter 24 (previously Chapter 25)

The following Core Reading definition has been updated:

Bancassurer

The term bancassurer usually applies to an insurance company that is a subsidiary of a bank or building society and whose primary market is the customer base of that bank or building society.

With-Profits Actuary

The associated Core Reading reference has been replaced by:

the Regulatory environment chapter.

3 Changes to the ActEd material

This section contains all the ***non-trivial*** changes to the ActEd text.

Throughout the course:

- references to 'his or her' have been amended to 'their' and
- dates have been moved forward from May 2021 to May 2022.

Chapter 2

Section 1.3

The second ActEd paragraph has been amended to:

Examples of tax advantages that might apply to pension products are given in the later chapters on Taxation.

Chapter 3

Section 1.2

One page 7, the fifth paragraph has been deleted and the first four have been updated to read the following:

As shown in the graph above, the FTSE 100 share index recovered to earlier highs by the end of 2007, fell significantly during the financial crisis of 2008-9 and subsequently recovered again. The drop in 2020 was a result of the COVID-19 pandemic and the resulting impact on the economy. The market has since shown signs of recovery and at the time of writing (May 2022) is almost at its pre-pandemic level.

Turning to UK interest rates, these were cut steadily from 6.0% *pa* in 2000 to 3.5% *pa* in 2003. They were then steadily increased from the end of 2003 to 2007. However, the slowdown in the world economy from 2008 resulted in a series of substantial cuts, with UK base rates falling to 0.25% *pa* in 2016. In early 2020, they were reduced to an all-time low of 0.1% *pa* in reaction to the pandemic, although have since gradually increased to 1% *pa* (May 2022).

In the UK, new business levels for conventional with-profits business are now close to zero, although significant volumes of in-force business still exist.

From its peak in 2005 (£420 billion assets in with-profits funds), the size of the UK with-profits market has been steadily reducing year by year. At the end of 2019, with-profits fund assets were around £250 billion.

Section 1.3

The following paragraph has been inserted below the first Core Reading paragraph under the sub-heading 'Insurer's perspective':

The recent global pandemic and the resultant volatility in the market, along with low interest rates, have also had a negative impact on UK with-profits business. It can be expected that the decline in sales volumes will continue, with more insurers closing their with-profits funds to new business.

In that same sub-section, the following paragraph has been inserted below the Core Reading sentence starting 'It can be profitable business ...':

Therefore some insurers that remain open to with-profits business, particularly mutuals, are investing in developing innovative new with-profits products. The intention is to combine some of the more attractive features of with-profits business, such as smoothed returns, with the transparency and flexibility that customers now require in products. For example, a relatively new style of with-profits product is described in the later chapter on Surplus distribution. Another example is a version that shares surplus by rebating charges rather than adding bonuses.

Chapter 4

Section 1.7

The ActEd text under 'Low interest rates' has been updated to read the following:

Low interest rates

In the UK, the Bank of England base rate is currently at 1% *pa* (May 2022), a little higher than its pre-COVID rate. This rate has increased from its lowest point of 0.1% *pa*, following the reaction to the COVID-19 pandemic and its adverse impact on the economy. Prior to this, the base rate had been at 0.75% *pa* or lower since March 2009, having previously remained below 6% *pa* since 2000. This was much lower than the rates experienced at times during the 1990s, when the base rate ranged from 5% *pa* up to nearly 15% *pa*.

Similarly, the federal funds rate in the USA is currently (May 2022) set with a target of 0.75% *pa* to 1.00% *pa*, which is significantly lower than it was at the start of the 1980s at around 14% *pa*.

Section 1.8

The final ActEd paragraph in this section (page 17) has been amended to:

For example, since around 2019, China has loosened regulations relating to foreign investment and consequently has opened up the country's insurance sector to overseas companies. However this may reverse, as at the time of writing (May 2022) foreign investors are fleeing China due to the country-wide lockdown following the global pandemic.

Section 1.11

There have been some updates to the ActEd text in this section, and this is covered in the replacement pages provided.

Section 2.9

The third ActEd paragraph on page 26 has been amended to:

In the USA, independent financial advisers remain the most commonly used channel amongst life insurance companies; this has not changed significantly over the last 10 years.

Practice Solutions

The solution to Question 4.5 has the following bullet point inserted under 'underwriting is critical', within the 'Keyperson' (replacing 'Keyman') section:

- Need to be careful when interpreting any information on mental health conditions. [1]

Chapter 8 (previously Chapter 9)

Section 3

A paragraph has been added to the end of this section and has been included in the replacement pages provided.

Section 6.2

The following ActEd paragraph has been inserted below the first Core Reading paragraph under 'USA' on page 20:

The concept of legislation differing at State level within the USA was mentioned in the chapters on Taxation.

Section 7.1

The first ActEd paragraph within this section has been shortened to:

Reviewing Actuaries are an example of a statutory actuarial role that is specific to the UK.

Chapter 9 (previously Chapter 10)

Section 5.2

The final ActEd paragraph has been extended to read as follows:

The UK was not automatically granted equivalence when it left the EU, despite still using Solvency II at that time. This reflected uncertainties about the extent to which the PRA might introduce changes to the solvency assessment regime, with the aim being to better calibrate the regime to the UK's insurance market. At the time of writing (May 2022), the UK has yet to be granted equivalence by the EU and the probability of gaining such will depend on how far the resultant regulations might deviate from Solvency II.

Chapter 10 (previously Chapter 11)

Section 2.1

The table on page 9 has been updated to the following and the sentence below it has been deleted. The rates are as at April 2022.

Term (years)	1	2	5	10	20	40
Euro	0.161%	0.868%	1.343%	1.643%	1.684%	2.255%
UK	1.872%	2.234%	2.104%	1.922%	1.770%	1.908%
USA	2.470%	2.987%	2.965%	2.929%	2.881%	2.267%

Chapter 11 (previously Chapter 12)

Section 2.1

The final ActEd paragraph at the bottom of page 4 has been amended. The new paragraph is included (at the top of page 5) in the replacement pages provided for this chapter.

Chapter 12 (previously Chapter 13)

Summary

The following bullet point has been inserted below the fourth at the bottom of the Summary page:

- customer vulnerability

Practice Questions

In Question 12.3 (previously 13.3), part (iii) has been removed and the marks for parts (ii) and new part (iii) (previously part (iv)) have been amended to 11 and 9 respectively. Replacement pages are provided for the updated solutions to these new parts (ii) and (iii).

Chapter 13 (previously Chapter 14)

Section 3.1

The following ActEd paragraph has been inserted at the bottom of page 9, before the Core Reading paragraph starting 'Proprietary companies would …':

A thematic review, carried out in 2019 by the FCA, criticised UK insurers with closed with-profits funds on the management of the run off of the inherited estate. As a result, such insurers are under close scrutiny to ensure their overall capital management approach for their with-profits fund(s) fairly balances the interests of different generations of with-profits customers.

Chapter 15 (previously Chapter 16)

Practice Solutions

The following amendments have been made to the solution to Question 15.1 part (iv) (previously Question 16.1).

Under the 'Mortality' heading, the first assurance factor (A) has been corrected to an equivalent annuity factor (ä).

Under the 'Change in valuation basis' heading, the statement of the final calculation has been corrected to:

= 5,114,959 - 5,658,822 = **– 543,863**

Chapter 16 (previously Chapter 17)

Practice Solutions

In the solution to Question 16.2 (previously Question 17.2):

- the heading 'Assumption changes and experience' has been amended to 'Assumption changes'
- the fourth point in that sub-section ('The CSM does not …') has been deleted
- the start of the fifth point in that sub-section has been amended from 'It also is not' to 'The CSM is not'.

Chapter 18 (previously Chapter 19)

Section 3.7

The final Acted paragraph of this section has been amended to:

There was some mention of this in the chapters on Taxation.

Practice Questions

The first paragraph of Question 18.3 (previously 19.3) has been amended to:

A life insurance company is calculating the asset share of a 25-year with-profits endowment assurance policy that is subject to the '*I-E*' taxation basis. It is considering the following three different approaches to allowing for tax:

Chapter 20 (previously Chapter 21)

Section 1.1

The following ActEd paragraph has been inserted at the end of the section:

The run-off plan should describe how the insurer proposes to manage the run-off of the with-profits fund, and should include details on how it is ensuring a fair distribution of the estate as well as how it is managing the associated risks. It should also include results from any stress and scenario testing carried out on the fund and details of subsequent management actions.

Section 3

The following ActEd paragraph has been inserted after the Core Reading bullet point list on page 14:

Various such management actions have been actioned following the COVID-19 pandemic, with the most popular action amongst UK with-profits companies being making changes to terminal bonus rates.

Practice Solutions

In the solution to Question 20.3 part (iii) (previously 21.3), the following amendments have been made in the final section headed 'Issues'.

The third point has been amended to:

The split of business between product types is likely to change over time, and this would impact the company's tax position if the products are subject to different taxation approaches. Therefore the portfolio mix should be modelled to project the likely tax position. [1]

The seventh point has been amended to:

If capital gains are not taxed until assets are realised (*eg* equities, property), the payment of this tax will be accelerated as the funds shrink. [½]

Chapter 21 (previously Chapter 22)

Section 8.3 (now Section 8.2)

The final paragraph has been amended to:

Examples of such controls include:

- business continuity plan – to enable operations to continue under extreme weather conditions
- investment strategy plan – setting out changes that should be made to the investment portfolio following specified movements in certain asset market values
- taking out / extending reinsurance cover – following increased mortality risk due to a climate change-related risk.

Practice Solutions

The final bullet point for Solution 21.6 (previously 22.6) has been extended to read as follows:

- Transition – higher than expected expenses in relation to the cost of transitioning, *eg* to assets from low carbon emission industries.

Chapter 22 (previously Chapter 23)

Section 3.4

The penultimate ActEd paragraph of the section has been amended to:

If tax is payable by life insurers on investment earnings, stating a sensible and well-reasoned investment return assumption is meaningless unless it is also specified whether it is gross or net of tax, and the appropriate tax rate if net. Investment returns could be stated on a gross basis, plus specification of the taxation basis and so whether or not they may then be netted down for tax.

Section 3.7

The ActEd paragraph at the bottom of page 14 has been amended to:

The impact of taxation will depend on the rules applicable in that jurisdiction and the category of business into which the contract falls for taxation purposes. For example, in the UK BLAGAB and non-BLAGAB should be considered individually. This is considered below with the aim to show how the details of taxation, which we have met earlier in the course, affect product pricing. There is nothing here that is particularly new – it is simply a question of considering the relevant current and likely future tax bases and how these should be allowed for.

The first two ActEd paragraphs at the top of page 16 have been amended to:

However, the corporation tax rate will influence the tax rate applied to profits as they emerge from the contract. Since shareholder profit is taxed at the corporation tax rate and the rest of *I*-*E* is taxed at the policyholder tax rate, a common approach is to net down *I* and *E* in the cashflows at the policyholder tax rate and then tax any emerging profits at the difference (if any) between the corporation and policyholder tax rates.

Proprietary in an 'excess E' situation

This could arise because expenses exceed investment income or because the minimum profits test bites. The first Taxation chapter provides examples of situations where the minimum profits test bites.

The Question and Solution on page 16 have been removed.

The following new sub-section has been inserted at the end of Section 3.7:

USA

As life insurance business generally does not suffer tax on the investment earnings, there may not be any allowance made for tax within the projection model used for pricing.

However, since tax is payable on profits, the emerging profit will need to be netted down (at the corporation tax rate) before being compared against the profit criterion.

Insurance companies are also subject to taxation on premium income. This premium-based tax can be loaded directly onto the modelled premium rates.

4 Changes to the X Assignments

There have been minor changes throughout the assignments.

More significant changes are listed below.

Assignment X1

Solution X1.3

The following point has been added below the first point:

… particularly by vulnerable customers. [½]

Assignment X2

Solution X2.1

Under the sub-heading 'The new taxation basis' within X2.1 (i), the second bullet point and the three lines following it (up to but not including the third bullet point) have been replaced with the following:

- whether any changes will be made to policyholder taxation, … [½]

  … particularly how benefits are taxed when received by policyholders [½]

- whether any restrictions placed on product design in order to achieve advantageous policyholder taxation treatment will be removed or amended [½]

  We have assumed that there will be no changes to these aspects.

Assignment X3

Solution X3.1

Reference to the chapter on Solvency assessment has been removed from the opening paragraph.

The following point has been inserted at the end of X3.1 (i):

Specific consideration should be given to how vulnerable customers are treated. [½]

The following point has been inserted at the end of the 'Communication' sub-section at the start of X3.1 (iii):

The company should consider any vulnerable customers and tailor the communication accordingly. [½]

Solution X3.2

The following point has been inserted at the start of page 13, after the point starting 'Also, if the premiums …':

The company should identify any potential areas of the underwriting process that may cause anxiety amongst vulnerable customers and tailor accordingly. [½]

Assignment X6

Solution X6.3

The following point has been inserted before the final point on page 15:

The individual underwriting approach might be more suitable in terms of meeting the needs of any particularly vulnerable customer. [½]

5 Other tuition services

In addition to the CMP you might find the following services helpful with your study.

5.1 Study material

We also offer the following study material in Subject SA2:

- Flashcards
- Sound Revision
- ASET (ActEd Solutions with Exam Technique) and Mini-ASET
- Mock Exam and AMP (Additional Mock Pack).

For further details on ActEd's study materials, please refer to the 2023 *Student Brochure*, which is available from the ActEd website at **ActEd.co.uk**.

5.2 Tutorials

We offer the following (face-to-face and/or online) tutorials in Subject SA2:

- a set of Regular Tutorials (lasting a total of three days)
- a Block (or Split Block) Tutorial (lasting three full days)
- an Online Classroom.

For further details on ActEd's tutorials, please refer to our latest *Tuition Bulletin*, which is available from the ActEd website at **ActEd.co.uk**.

5.3 Marking

You can have your attempts at any of our assignments or mock exams marked by ActEd. When marking your scripts, we aim to provide specific advice to improve your chances of success in the exam and to return your scripts as quickly as possible.

For further details on ActEd's marking services, please refer to the 2023 *Student Brochure*, which is available from the ActEd website at **ActEd.co.uk**.

5.4 Feedback on the study material

ActEd is always pleased to get feedback from students about any aspect of our study programmes. Please let us know if you have any specific comments (*eg* about certain sections of the notes or particular questions) or general suggestions about how we can improve the study material. We will incorporate as many of your suggestions as we can when we update the course material each year.

If you have any comments on this course please send them by email to **SA2@bpp.com**.

1.11 Pandemics

At the time of writing (May 2022) the coronavirus pandemic has had a significant impact on the health of the population in many countries and more widely on the global economy. The long-term impacts of the coronavirus pandemic (for example on mortality and morbidity rates) and understanding the reasons for significant differences in experience between countries and different population sub-groups is likely to take some time.

This version of the Core Reading will not go into more detail on the coronavirus pandemic itself.

Globally, the World Health Organisation recognises that infectious disease in the form of a pandemic presents a huge threat to global health.

There have been several significant pandemics in the last two hundred years, mostly from influenza ('flu) viruses. These include the Spanish influenza of 1918-1920 with an estimated worldwide death toll of at least 50 million.

The HIV / AIDS pandemic that was first recognised in the 1980s remains active. Although now better managed through developed drugs, over 30 million have died from AIDS-related illnesses.

At the time of writing (May 2022), global deaths from COVID-19 are over 6 million – and this figure continues to increase.

The UK national risk register from 2017 considered that emergence of a pandemic influenza and or a new infectious disease could lead to a civil emergency, and the threat was considered to be equal to or higher than that of extreme weather events. The report also indicated that there was considerable uncertainty about the timing of any event and what it would look like.

The risk of infectious diseases emerging has increased due to human impact on the environment. For example, both the increased demand for meat due to a rising global population and deforestation leading to more intensive farming have put humans and animals in closer contact. This increases the risk of pathogens spreading from animals to humans. Whilst this risk is not new, the probability of a pandemic event occurring in the future has increased.

Pandemics have the potential to materially impact all aspects of a life insurer's business.

As well as the clear link with mortality and morbidity rates, there could be significant impacts on:

- economic growth and therefore related factors such as asset values and demand for products
- operational aspects, including staff sickness.

The potential impact of pandemics on life insurers is likely to be an important consideration for regulators. In particular, regulators are likely to want to ensure that life insurers have sufficient capital to meet policyholder liabilities in the event of a pandemic. Regulators may wish to see life insurers carry out stress testing to show that they are resilient to realistic pandemic scenarios.

The COVID-19 pandemic has also caused an increase in demand for life insurance. Around 6 million UK adults have been prompted to purchase or consider purchasing life insurance directly as a result of the pandemic, comprising around a third of those who have bought or have thought about buying such products at some point.

1.12 Mental health

Attitudes towards mental health have shifted in recent years, and this has implications for life insurance companies.

It is estimated that, each year, one in four adults experience a mental health problem. They range from common problems, such as depression and anxiety, to rarer problems, such as schizophrenia and bipolar disorder. Our understanding of the causes of mental health conditions – and how they are treated – has developed radically in the last century.

People with mental health problems can experience barriers in their everyday life, and these can be exacerbated when dealing with complex consumer products, such as insurance policies. Life insurance companies therefore need to consider carefully how they engage with customers (and employees) about their mental health, in order to remove barriers and to meet the needs of these customers.

Mental health conditions can also be directly relevant to underwriting. The life insurance industry needs to ensure that all underwriting decisions are based on the best information available and should seek to improve this information where possible. Mental health is also often associated with other issues, such as financial stress and comorbidities.

Comorbidity refers to the situation where a person is suffering from more than one condition at the same time, with or without any causal relationship between them. The conditions are typically chronic and long term.

The industry should seek to understand the effects that may confound with other factors.

In other words, it is important for the insurer to understand any relationship there might be between a mental health condition and other factors that are relevant to the individual's morbidity or mortality risk level.

Life insurance companies should also seek to be as transparent as possible about underwriting decisions and the pricing aspects of mental health.

It is important to explain clearly to the individual how and why their mental health condition has impacted the premium rate charged and/or any terms and conditions imposed, *eg* exclusions. Although such decisions may be unwelcome, understanding the rationale behind them can make them more palatable.

2 Distribution of products

2.1 Propensity of consumers to purchase products

Life insurance products are typically thought of as a product that is sold, not bought. Although people know they should take out life insurance policies to provide lump sums or an income for the benefit of their dependants, or should save regularly to provide a pension when they retire, many have been reluctant to do this.

Reasons for this reluctance include:

- a desire to live for now rather than save for the future
- a feeling that the State will always provide
- lack of money
- lack of incentives from the government
- fear that personal provision may be wasted if State provision is means-tested (*ie* reduced or not paid if the individual has other income or capital)
- lack of trust in the savings industry.

People would often rather spend their money as they earn it on more tangible benefits – cars, holidays, houses, eating out, entertainment – than provide for a future that they know will happen but which they cannot bring themselves to think about.

There may be particular challenges for life insurers selling in developing markets, as it is possible that a significant proportion of the population may be on a low income and may not have sufficient disposable income to purchase a life product.

A consumer's inclination to save is increased if there is an incentive. This could be:

- **tax-related with tax relief on premiums or contributions, or tax-free benefits**
- **to protect an inheritance**
- **loan-related, with the consumer being more willing to effect a life policy that will repay an outstanding loan on death, if effecting the policy makes it more likely that the lender will provide the loan**
- **employer-related, such as if an employee contributing to a company pension scheme means that the employer will also contribute.**

Better education on the need to save, or on the consequences of not saving, might also improve the inclination to save.

There are, nevertheless, many people who *will* make provision at their own initiative. These are more likely to be those people who can afford to do this as well as enjoy more tangible and immediate benefits.

In many jurisdictions, sales of life insurance products have historically been made through:

- **financial advisers**
- **agents (single or multi-tied)**
- **direct.**

6

Taxation (1)

Syllabus objective

2.2 Explain the general principles of the taxation of life insurance business from the perspective of:

- governments
- policyholders
- life insurance companies.

0 Introduction

This chapter and the next look at the taxation of life insurance products.

In particular, they cover the principles around life insurance taxation and give examples of the different possible approaches to taxing life insurance policyholders and companies.

This chapter introduces the various principles that might be applied and approaches that could be taken to the taxation of life insurance business. It considers each of the following perspectives:

- governments
- policyholders
- life insurance companies.

The next chapter looks in a little more detail at how these approaches have been adopted in specific jurisdictions.

1 Government perspective

1.1 Aims of taxation

The general aim of taxation for a country is normally to raise revenue to meet the needs of its citizens (*eg* to pay for hospitals, pay pensions, *etc*). Governments will need to balance many competing priorities for taxation revenue.

Taxation is normally the main source from which governments raise money. The pressures of trying to meet the wide range of spending needs from the tax revenue raised are common across the world.

Governments will generally set out high-level taxation principles which will reflect how they wish to balance these competing priorities, and whether they wish to promote particular economic or social goals via the taxation system. For example, a possible goal could be to have a taxation system that is broadly neutral between equivalent companies, products and services.

'Equivalent companies' means companies that are effectively doing the same thing, even though they might be operating within different industry sectors. For example, the taxation system might aim to ensure that:

- supermarkets selling insurance are taxed in the same way as insurance companies
- products sold by investment or fund management companies are taxed in the same way as savings products sold by life insurance companies
- all companies pay tax on the same basic amount, *eg* trading profits.

1.2 Complexity

Most countries will have detailed taxation frameworks in place that will set out the taxation treatment of companies in that country and of the products and services they sell.

In developed countries, the overall taxation framework may have evolved over many years and can be very complex. Care is required to ensure that the taxation system is not excessively complex to administer for the tax authorities, nor excessively complex to comply with. Similarly, changes in the taxation framework need to be considered carefully to ensure they are not overly onerous to comply with and do not cause unintended consequences.

'Unintended consequences' refers to a situation where a change has been implemented in order to resolve or improve a particular area of taxation, but which has inadvertently caused an unexpected and unwanted impact on another aspect. In particular, it might open up loopholes which could be exploited.

1.3 International considerations

Governments will also need to consider how comparable their country's taxation framework is with those of other similar countries. Does the government wish the taxation framework to be more, or less, onerous than those of other equivalent countries?

For example, it might want to consider how onerous the tax framework is compared with those of other countries within any trading union it belongs to, such as the European Union.

Consideration would also need to be given to the taxation treatment of domestic companies and any foreign-based companies selling in the country.

For example, the government of a country that does not have a strong domestic insurance industry might want to give favourable tax treatment to a foreign insurance company to encourage it to set up operations there, *eg* to establish a microinsurance market.

On the other hand, a government might want to impose higher taxes on foreign insurance companies in order to protect its domestic insurers.

Governments will also need to consider whether there are any external drivers that could impact the country's taxation framework. For example, a country may participate in international tax agreements which set limits on certain aspects of countries' taxation frameworks, such as minimum tax rates.

An example of such an agreement is the OECD Global Anti-Base Erosion (GLOBE) 'model rule', which is designed to ensure that large multinationals pay a minimum level of taxation of 15% in each jurisdiction in which they operate. The EU intends to introduce 15% as the minimum effective corporation tax rate for large corporate groups operating there, whether multinational or domestic.

2 Overview of life insurance taxation

2.1 Introduction

The taxation framework for life insurance business in a particular country will set out the taxation treatment of:

- **the policyholder (and other policy beneficiaries – for example, the policyholder's dependants)**
- **the life insurance company in respect of the business it has sold.**

The level and form of life insurance taxation can vary significantly between different countries. Different possible approaches are considered in subsequent sections of this chapter and in the next chapter.

2.2 Adjustments needed for life insurance

Life insurance has particular features which mean that adjustments may need to be made to the standard taxation framework for a particular country. In particular:

- the long-term nature of life insurance business
- the potential need for customer incentives.

Long-term nature

Determining a life insurance company's profit is a challenge compared to many other types of company. A life insurance company may see profits emerge on a policy many years after the policy was actually written. Similarly, a policyholder may not receive any payout on their policy until many years after the policy commenced.

Life insurance business is typically written as 'long-term business'. The actual amount of profit earned is not known until the end of the policy, which may be decades after the contract was issued.

Incentives

Governments may choose to offer taxation advantages to encourage its citizens to purchase life insurance. The argument for offering these incentives is that life insurance can play an important economic and social role in a country.

The concept of offering tax incentives was introduced in the chapter on the General business environment.

For example, life insurance can:

- **provide financial protection against the adverse financial consequences of death or illness**
- **allow individuals to save in a convenient manner for particular events, such as to provide an income in retirement**
- **relieve potential pressures on a country's social welfare systems, as the proceeds of insurance could mean that individuals do not need to rely on the State.**

In particular, in order to encourage individuals to save for retirement and therefore reduce the burden on State pension provision, governments might offer tax incentives on pension products offered by life insurers.

Where favourable tax treatment is offered to life insurance business, it is common for there to be limitations on the tax-advantaged status of life insurance products.

Limitations could take many forms. For example:

- **different forms of life insurance business could receive different tax treatment**
- **only certain sub-groups of policyholders could be permitted to access tax-advantaged products**

  For example, there may be mean-testing in place whereby only those with incomes below a specified threshold could be permitted to buy a certain product, or there may be age restrictions imposed.

- **there could be limits on the sum assured or contributions.**

  For example, there could be limits placed on the amount of premiums that can be paid into a tax-advantaged policy. Examples of this are 'qualifying' life assurance savings products in the UK or certain endowment assurance contracts in the USA (as was mentioned in the first chapter on Life insurance products).

2.3 Other considerations

Similar products

Governments will need to consider carefully whether the taxation treatment of life insurance business could lead to life insurance products having an advantage (or disadvantage) relative to other equivalent products.

As described in Chapter 4 (General business environment), the taxation environment can have a significant impact on the business written by a life insurance company. The tax treatment of life insurance business may make it more, or less, attractive relative to equivalent products offered by other types of financial institution which are subject to different tax rules. This can influence policyholders' buying habits.

For example, the government might want to ensure that it is no more or less attractive (from a taxation perspective) to purchase a life insurance savings contract than it is to invest directly with a fund management company.

Product design

Life insurance product design will often also be influenced by the taxation environment.

For example, adding a specific feature to a product (such as a minimum death benefit) could enable that product to receive favourable tax treatment for the policyholder.

Including a minimum death benefit might mean that the product can now be classified as protection business rather than savings, and these two types of product might be subject to different tax treatments.

Complexity

Life insurance companies in developed countries with sufficient infrastructure may be able to comply with a complex taxation framework. However, a complex taxation framework may not be workable for less developed countries with a less developed life insurance industry.

As an example of this, the life insurance taxation framework that applies in the UK is considerably more complex than that in China – as will be seen in the next chapter.

3 Policyholder taxation

3.1 Introduction

This section considers life insurance taxation from the policyholder perspective.

Policyholders (or other policy beneficiaries) will normally be taxed on the life insurance products they have bought. The form of taxation can vary considerably between countries, and even between different types of life insurance business in a country.

For example, it might differ between pensions business and other business, and/or between protection business and savings business.

As outlined in Chapter 1, the premise of life insurance is that a policyholder will pay a premium (or premiums) to the insurer and in return they will receive a promise from the insurer that they or their dependants will receive a benefit (or benefits) in certain circumstances (*eg* on death, maturity, surrender or retirement), which could be many years after the product was originally sold.

The taxation treatment of the following components needs to be considered in relation to the taxation of life insurance business from the perspective of the policyholder:

- **the premiums paid**
- **investment earnings on the accumulation of premiums or funds within the life insurance company**
- **the benefits received**
- **any additional taxation.**

  For example, there might be other types of taxation applied to the proceeds received from the policy than just normal life insurance policy taxation.

These are considered further below.

3.2 Premiums paid

The premiums paid into a life insurance product can be treated in different ways with regards to taxation. For example:

- **The premiums may be paid out of policyholders' post-tax earnings.**

  Therefore the policyholder has effectively already paid income tax on those premiums, and no tax relief is being given.

- **Policyholders may receive tax relief on premiums paid, so that a policyholder's income tax is paid only on earnings net of the premium paid.**

  In other words, the amount of earnings on which the policyholder pays normal income tax is the amount calculated *after* the premium has been deducted. Under this approach, the policyholder would normally only receive tax relief if they were subject to tax on their income. If they have low earnings that would not be taxable, there would be no tax relief.

- **Additional tax may be levied on the premiums paid by the policyholder (although in most countries life insurance policies are exempt from insurance premium tax).**

  This approach is more common for short-term insurance products, such as general insurance and medical insurance. For example, in the UK 'insurance premium tax' applies to premiums paid for products such as motor, house, pet and travel insurance.

Where tax relief is given on premiums there will often be restrictions.

Such restrictions generally aim to:

- ensure that individuals are not exploiting the tax advantages
- avoid the more affluent gaining disproportionately.

For example:

- **There may be limits on the amount of any tax relief that is available, such as restrictions on the amount of annual premium that can receive tax relief.**

  For example, this applies in the UK – as will be mentioned in the next chapter.

- **Tax relief may only apply to certain types of product. For example, premiums paid for products whose main purpose is to provide death benefits may not get tax relief, but those for products where the purpose is to save for retirement may get tax relief to encourage policyholders to save.**

  This reduces the burden on the State of supporting individuals in retirement.

- **Tax relief may only apply to certain contributions. For example, tax relief may apply to contributions from the individual but not any contributions from the individual's employer. In other cases, the premium may be treated as a deduction for corporation tax purposes, so that an employer may be able to reduce its taxable profit by the amount of any premium that the company pays, and so reduce the amount of corporation tax that the company pays on its profits.**

  In other words, subject to meeting relevant requirements, an employer might be permitted to treat pension scheme contributions as a business expense and therefore deduct them from taxable revenue.

3.3 Investment earnings

The investment returns earned on the accumulation of premiums within the insurer can also be treated in different ways for taxation.

For example:

- **Investment returns could roll up free of taxation – this is sometimes referred to as a 'gross roll-up basis'.**
- **Investment returns could be subject to taxation – possibly after deducting the insurance company's expenses.**

Where investment earnings would generally be tax-free for certain products, there may be some types of asset that are excluded from this tax relief, such as investment in residential property held within pension policies.

Taxation of investment returns minus expenses within the insurer is described further in Section 4.4.

3.4 Benefits received

The approach to taxation of the benefits received from a life insurance product by the policyholder (or other policy beneficiaries) can vary between countries.

For example:

- **the policyholder may receive the benefit from the life insurance product free of any further taxes**
- **part of the benefit may be taken tax-free**
- **tax may be payable on the full benefit**
- **tax may be payable on the excess of the benefit received over premiums paid.**

  The excess of the benefit received over premiums paid may be referred to as the 'chargeable gain'.

Type of benefit

Different types of benefit may be treated differently for taxation purposes. For example, in some jurisdictions contractual death or maturity benefits on some products may be tax-free, but tax may be due on surrender and partial surrender benefits.

Tax rate

Where additional tax is payable by the policyholder on their benefit proceeds, this may be at:

- **the policyholder's normal (marginal) rate of income tax**

  The marginal tax rate is described further below.
- **the excess, if any, of the policyholder's marginal rate of income tax over a basic rate of income tax**
- **the rate of tax applied to capital gains**
- **a different specified rate.**

Marginal tax rate

In many countries individuals will pay different levels of tax depending on their level of income. For example:

- **no tax may be due on income up to a certain threshold**
- **x% tax may apply to the next level of income above that threshold but up to a second level**
- **y% tax may apply to income in the next band above that level, *etc*.**

Therefore, the individual only pays each specified tax rate for a particular band of income.

An individual's marginal tax rate is the tax rate they pay on an additional unit of income, so would normally be the tax rate payable on the highest band into which their total income falls.

For example, if tax is payable at a basic rate of 20% on all income between $10,000 and $40,000 and at a higher rate of 50% on all income over $40,000, the marginal tax rate of someone with an income of $25,000 would be 20%, and that of someone with an income of $45,000 would be 50%.

Where the policyholder is liable to tax only at the excess of their marginal rate of income tax over the basic rate (*eg* 30% in the above example for the individual with an income of $45,000), this may be because the insurance company will have been effectively paying tax at the basic rate on the 'policyholder profit'. This is described further in Section 4.4.

Hence the overall amount of tax collected is broadly the same as if the policyholder had been taxed at their full marginal rate, but the insurance company is paying part of that amount directly to the tax authorities itself. This cost is normally passed on to the policyholder through the pricing of the product.

The tax authorities want to receive overall tax on the policyholder's gain at the appropriate rate of income tax for that individual. They do this by taking:

- tax at the basic rate from the insurance company – which then aims to collect this back from the policyholder (*eg* when setting premium rates or unit prices)
- tax at the {marginal rate minus basic rate} from the policyholder, where this is greater than zero – typically through the tax returns that higher-rate taxpayers are likely to be required to submit.

Limits

Where tax advantages are given in relation to a particular product, for example for pension savings, there may be limits on the amount of benefit that can be purchased or accrued within that tax-advantaged environment. Additional tax charges may then be applied to amounts in excess of that limit.

An example of this is the 'lifetime allowance' on UK pensions business, as will be mentioned in the next chapter.

3.5 Additional taxation

In some countries, additional tax may be applied to the proceeds from a life insurance policy in particular circumstances.

For example, in some countries inheritance tax may be due on the accumulated wealth of a policyholder who has died, and the proceeds from the life insurance policy could be included in the policyholder's accumulated wealth.

This is not considered further in this chapter.

3.6 Relationship between the tax treatment of premiums, investment growth and benefits

The government will need to consider the combination of the tax treatment of the premiums, investment returns and benefits paid on a life insurance policy, to ensure the overall level of taxation paid by the policyholder is appropriate.

It would be unusual for governments to be generous in terms of the tax treatment of all of premiums, investment returns and benefits for policyholders, as this could lead to an over-generous overall position.

It is more common for there to be some limitations on the taxation benefits. For example:

- **If tax relief is given on premiums paid into the policy, then the benefit payouts to the policyholder would tend to be taxable.**

  This is often the case for pensions products.

- **If premiums paid into the policy are from post-tax earnings, then only benefit payouts in excess of the premiums paid would tend to be taxable rather than the full benefit.**

  This is often the case for other (*ie* non-pensions) life insurance savings products.

Similarly, it would be unusual for a government to impose more taxation on any savings element of a life insurance policy than would be incurred by using other savings vehicles, as this would make the life insurance product uncompetitive.

4 Life insurance company taxation

4.1 Introduction

This section considers life insurance taxation from the insurance company perspective.

A life insurance company will generally need to pay tax on the business it has written.

There are different possible approaches to determining the taxation paid in respect of the business sold by a life insurance company. The most common methods of taxing a life insurance company on the business it has written are taxing:

- **the commercial profits made by the insurance company on the business written**
- **investment earnings less some or all of the operating expenses of the company**
- **the premium income of the business written.**

The life insurance company may also be subject to other forms of taxation that apply to any operating company, such as employment-related taxes, tax on goods and services purchased, and foreign withholding taxes on foreign investment income. These are not considered further in this subject.

Withholding tax is a tax that is levied by an overseas government on investment income received by non-residents. There may be an arrangement between countries by which all or part of such tax could be reclaimed.

4.2 Classification of business for tax purposes

As mentioned in Section 2, in some jurisdictions different types of life insurance business may be treated differently for tax purposes. Where this is the case, life insurance companies are required to classify their business into separate categories to ensure each category is treated appropriately for tax.

Taxation legislation would include rules as to how this classification should be done.

Separating the business for taxation purposes requires the company to divide and apportion its profit and other accounting information between these tax categories. Although this is clear for many accounting items, there may be an element of judgement required for some.

There are likely to be rules as to how this apportionment should be performed, but these may not be straightforward to apply for all possible accounting items and situations.

Tax authorities may provide guidance on how the accounting information is divided between categories, and the level of granularity needed in this apportionment. This is in order to avoid distortions in the tax result, such as those that could arise from high-level apportionments of investment returns and expenses between the different types of business written.

As is described below, investment returns and expenses may form the basis of a life insurance company's taxation calculation for some of its business. The tax authorities would be keen to reduce the scope for insurers to be able to manipulate the apportionment of these items between business categories in order to minimise or avoid tax.

4.3 Taxation of profits

For business where tax is payable on the annual profits arising, the term 'profits' means the excess of the change in the value of the assets over the change in the value of the liabilities.

This is typically based on the trading profits arising in the statutory accounts, *eg* under IFRS or local GAAP.

IFRS (International Financial Reporting Standards) are described in the later chapter on Profit reporting. Local GAAP refers to the generally accepted accounting principles that apply within a jurisdiction.

Where taxation is based on trading profits, tax calculations can be materially impacted by changes in accounting policy, such as the introduction of IFRS 17. Therefore the tax authorities will often introduce special provisions to alleviate this impact, such as transitioning the change (for tax purposes) over a given period of time (*eg* ten years) in order to smooth out any additional tax burden.

This taxation approach (*ie* taxing profits) is normally associated with business that benefits from the gross roll-up of investment earnings (see Section 3.3).

Question

Explain why taxing the life insurance company on its profits is normally associated with business where investment earnings accumulate free of taxation.

Solution

If both the investment earnings and the eventual profits were taxed, this would effectively result in double taxation of the investment earnings, since these form part of profits.

This would therefore be an example of an overly punitive taxation approach, which would likely be perceived as unfair to providers and, to the extent that the cost is passed on to them, customers.

Trading profit will broadly comprise premiums + investment return (including unrealised gains) – claims – expenses – increase in liabilities.

The expenses will normally be the 'full 'expenses, *ie* the acquisition expenses are not spread in the way that they might be under the '*I*-*E*' approach that is described in the next section.

Question

Show that the trading profit calculated using the normal formula

$$\text{Profit} = P + I - C - E - (V_1 - V_0)$$

is equivalent to the excess of the change in value of assets over the change in value of liabilities.

Solution

Assets at the end of the year equal assets at the start of the year plus net cashflows in, including all investment earnings:

$$A_1 = A_0 + P + I - C - E$$

Therefore:

$$P + I - C - E - (V_1 - V_0) = (A_1 - A_0) - (V_1 - V_0) \text{ as required.}$$

The tax rate used is normally the corporation tax rate that would apply to the profits arising in any type of trading company.

If trading losses arise in a year, it may be possible to use these losses to offset taxable profits in other years or in other companies within the group. However, there may be restrictions on the extent to which this is possible.

For example, it may be possible to carry the loss forward and offset it against profits arising in a future tax year, but with this being restricted to a maximum future period (*eg* three years) and/or a maximum proportion of the profits arising. It may be possible to carry the loss backwards in order to offset it against profits arising in the previous tax year.

Typically, mutual life insurance companies would not be subject to any taxation on trading profits.

A mutual would not be expected to have any trading profit, as any surplus made would ultimately be passed back to the with-profits policyholders as bonuses. Therefore it would not be subject to profits-based taxation.

4.4 Taxation of investment earnings minus expenses

'*I-E*' basis

Determining tax on the excess of investment earnings over expenses may be referred to as the '*I-E*' basis or method.

This is pronounced as '*I* minus *E*'.

'*I*' refers to total investment earnings, although this may exclude certain items, such as dividend income from equities and unrealised gains on equities and property.

'*E*' refers to expenses, possibly with the spread of acquisition expenses over a defined period. It might also include a carried forward amount of excess expenses from the previous tax year, referred to as 'excess *E*' or XSE. This is explained further below.

Dividend income from equities is sometimes referred to as *franked* investment income (FII). It is typically not included as a component of *I* because it is not subject to tax in the hands of the recipient. Tax has effectively already been paid on dividend income at source, since dividends are paid from companies' post-tax profits.

Typically, gains on equities and property would not be taxed as part of *I* until the gains are realised. The tax framework may permit an indexation adjustment to be applied to these chargeable gains, meaning that only gains earned in excess of inflation are taxable. It would typically be the case that realised losses could be offset against realised gains, possibly across different tax years, but the losses would normally not be adjusted for indexation.

Question

In a particular jurisdiction that uses the '*I-E*' taxation approach, capital gains on equities and property are not taxed until they are released, but unrealised gains on bonds are taxable.

Discuss whether this means that equity and property investments, which generally give much of their return through capital gains, are more tax-efficient investments for life insurance companies than bonds.

Solution

This is true to some extent, although it should be borne in mind that the gains will be taxed when they are eventually realised and companies will normally set up deferred tax liabilities to reflect this. (This is considered further in the next chapter.)

Another potential advantage is that the insurance company may benefit from indexation relief on equity and property gains and this may not be the case for gains on bonds.

Also, income on equities may well not be included in the *I* part of the tax calculation.

Shareholder profit and policyholder profit

The aim of the '*I-E*' basis is to approximate the overall impact of taxing both shareholder profit, *ie* normal trading profit, and policyholder profit within the life insurance company.

Simplistically:

Shareholder profit = premiums (*P*) + investment return (*I*) – expenses (*E*) – claims (*C*) (where claims include increases in policy liabilities) = *P + I – E – C.*

This is basically the same as the trading profit formula stated in the previous section, simplified so that 'claims' includes the increase in the value of liabilities. This is reasonable since, as will be considered in the chapter on Profit reporting, holding provisions against liabilities does not impact the total profit arising, only the pace at which it emerges.

This can be rewritten as:

Shareholder profit + *C – P = I – E.*

Since policyholder profit is the excess of claims over premiums, *ie C – P*, we can see that *I – E* is the sum of shareholder profit and policyholder profit.

Alternatively: shareholder profit + policyholder profit = $P + I - E - C + C - P = I - E$.

Hence if both shareholder profit and policyholder profit are taxed, the total taxable amount is *I-E*.

If shareholder profit and policyholder profit are taxed at different rates, it is necessary to split this amount into those two components.

To do this, the shareholder profit component is broadly taken as the trading profit arising – possibly subject to adjustments or restrictions.

For example, the shareholders' share of dividend income might be deducted from the taxable trading profit as it is deemed to have already been subject to taxation at source (as noted earlier). There might also be a restriction imposed so that the minimum taxable amount is zero.

The policyholder profit component is then the excess of *I* – *E* over that amount.

The shareholder profit component would typically be taxed at the normal corporation tax rate, in line with the approach taken in Section 4.3.

Since policyholder profit is largely the investment return earned on policyholder assets, this component of the *I* – *E* amount would be taxed at a 'policyholder tax rate', which is typically the same as the tax rate applied to individuals' directly earned investment income.

The 'policyholder tax rate' used within the life insurance company tax calculation would normally be the basic rate of income tax.

This enables the tax authorities to collect tax on the policyholder profit at the base rate directly from the insurer, leaving the policyholder to pay any additional tax that is due if they are a higher rate taxpayer – as indicated in Section 3.4.

In a mutual, all of *I* – *E* would typically be treated as policyholder profit.

For a mutual insurer, there will be no shareholder profit. Hence the policyholder profit component (*ie* the excess of claims received over premiums paid) must arise from investment income and gains less expenses.

Minimum profits test and XSE

The tax authorities may require life insurance companies to pay a minimum amount of tax in line with the taxation of any trading company, for example corporation tax on trading profits.

This aims to treat different types of trading company equivalently.

Where that is the case, a 'minimum profits test' is applied to proprietary companies for any business taxed under the '*I-E*' basis. Broadly, this means that the taxable amount is the higher of '*I-E*' and the trading profits of the company.

If there is a trading loss, this would typically be set to zero for the purposes of the minimum profits test.

It may be possible to carry forward some or all of any losses, to reduce profits in future years.

Another adjustment, as mentioned earlier, might be to deduct the shareholders' share of dividend income from the trading profit used in the minimum profits test. For those jurisdictions where dividends are excluded from *I*, this would ensure that the adjusted trading profit amount is directly comparable with '*I-E*' when the test is applied.

The shareholder profit component remains equal to the adjusted trading profit amount, but if the minimum profits test bites (*ie* trading profit is higher than *I-E*) there is no policyholder profit component.

The 'minimum profits test' is only required for proprietaries because a mutual has no shareholder profit, and thus the whole amount is treated as policyholder profit.

An overview of the process for a proprietary company is as follows:

- A quantity called minimum profit is determined as a measure of the shareholder profit arising for the year. This is broadly taken as the trading profit, possibly with some adjustments (*eg* setting a loss to zero).
- This amount is typically subject to tax at the standard rate of corporation tax.
- The remainder (if any) of the taxable income in the *I-E* computation is denoted the policyholder profit, and this is typically taxed at the basic rate of income tax.

The separation of the taxable amount into shareholder profit and policyholder profit is important where the two tax rates used differ.

Question

Consider a proprietary life insurance company with two categories of taxable business:

- Fund 1 business is subject to the *I-E* taxation basis
- Fund 2 business is taxed on trading profits.

Fund 1 *I-E*	200
Fund 1 trading profit	110
Fund 2 trading profit	140

It can be assumed that no minimum profit adjustments are required.

Calculate the amount that would be taxed at:

(i) the corporation tax rate

(ii) the policyholder tax rate.

Solution

(i) 250 (= 140 + 110) would be taxed at the corporation tax rate.

(ii) 90 (= 200 – 110) would be taxed at the policyholder rate; this is the excess of *I-E* over 'minimum profit'.

Excess *E*

If the minimum profits test bites, the company is deemed to not have been able to relieve all of its expenses and is permitted to carry the unrelieved amount of '*E*' forward into the next tax year.

The minimum profits test 'bites' when the minimum profit amount is higher than '*I-E*'.

The key situations in which this happens for a proprietary company are when the company has one or more of the following:

- low (or negative) *I*
- high *E*
- high minimum profit.

The company is said to be in an XSE ('excess *E*') position.

If the minimum profits test does not bite, the company is said to be XSI.

When the minimum profits test bites, and the company is XSE, the *E* of the following period would be increased by the excess of minimum profit over '*I-E*'. This amount is referred to as 'unrelieved expenses' or 'excess E'.

In other words, the insurance company has not been able to gain relief for all of its *E* in the *I-E* calculation for the current tax year, since it has had to pay tax on a higher amount (minimum profit). It is therefore given the opportunity to carry that unrelieved amount of expenses forwards, to enable it to be offset against *I* in the following tax year.

Question

A company has calculated its *I-E* amount as follows:

$I\text{-}E = 250 - 150 = 100$

For each of the following scenarios, assuming that there are no further adjustments required to the figures:

(i) State whether the minimum profits test bites.

(ii) State the amount of XSE that can be carried forward to the next year, if any.

Scenario 1: minimum profit = 50

Scenario 2: minimum profit = 170

Scenario 3: minimum profit = 350

Solution

Scenario 1: The minimum profits test does not bite, so there is no XSE.

Scenario 2: The minimum profits test is biting. As a result, the company is XSE and it can carry forward XSE of 70 (= 170 – 100) to the next tax year.

Scenario 3: The minimum profits test is biting. As a result, the company is XSE and it can carry forward XSE of 250 (= 350 – 100) to the next tax year.

For example, being XSE may arise:

- **due to significant falls in the market value of bonds**
- **if the company is new and so has a relatively low level of income but large expenditure**
- **due to a significant weakening of the liability valuation basis, creating a large trade profit and therefore causing the minimum profits test to bite.**

Profit is essentially:

$$(P - C) + (I - E) - (V_1 - V_0).$$

Thus *'I-E'* is actually a part of the profit calculation, although the definitions of *I* and *E* may not be quite the same between the two calculations. Therefore anything that affects premiums or claims or the change in reserves, but not *I* or *E*, will tend to change the balance between an *I-E* assessment and a minimum profits assessment. Equally, different treatment of *I* or *E* in the two assessments will affect their relative sizes.

Weakening the valuation basis reduces V_1 and so increases reported profit. This makes it more likely that the minimum profits test will bite and therefore more likely that the company will become XSE.

Question

Explain why significant falls in the market value of equities is not given as an example of why a company might become XSE.

Solution

If the losses are unrealised, then they might be excluded from *I* and hence there may be no change in *I-E*.

The capital losses would, however, reduce the *profit* arising from investment earnings.

There may be an offsetting reduction in liabilities, *eg* if the business is unit-linked or with-profits (as seems likely given that the company is invested in equities).

So, overall, there also may be no material change in minimum profit. Alternatively, minimum profit might even *reduce* due to losses on equities backing surplus assets.

The company is therefore likely to stay on the same XSI or XSE basis as before the market fall, or might even move from an XSE to an XSI basis (if profit has reduced to the extent that it no longer 'bites' in the minimum profits test).

Although a mutual does not perform the minimum profits test, it would be said to be XSE if $I < E$. Under that situation, it would pay no tax but could carry forward the unrelieved expense amount of $E - I$ with the aim of gaining tax relief on it in a future tax year.

4.5 Taxation of premium income

Insurance companies may also be taxed on premium income, as a type of sales tax.

Premium taxes can be used to protect domestic insurers from foreign insurers, by imposing higher tax rates on the latter.

A premium-based tax has some advantages – it is simple to calculate and verify.

However, it also has some disadvantages. For example, it is more onerous for life insurance policies with higher premiums.

Life insurers will normally pass on the cost of taxes incurred to policyholders, so if a tax that is expressed as a percentage of premiums is charged directly this could lead to lower average policy sizes and hence reduced profit.

Taxation based on premium income is a more common method of taxation for short-term business such as general insurance or health insurance. It is not common for long-term insurance products with an investment component.

The chapter summary starts on the next page so that you can keep all the chapter summaries together for revision purposes.

Chapter 6 Summary

Government perspective on taxation

Governments may have the following aims in relation to taxation:

- raising sufficient revenue to meet the needs of citizens (*eg* healthcare, pensions)
- broad neutrality between economically equivalent companies and products.

Governments will also consider the following, in relation to the taxation framework:

- the level of complexity (should not be too difficult to administer or comply with, particularly in less developed countries) and avoiding unintended consequences
- comparability with the frameworks in similar countries, the treatment of domestic *vs* foreign companies and any restrictions imposed by international agreements.

Overview of life insurance taxation

The taxation of life insurance companies may differ from the standard tax framework due to:

- the long-term nature of life insurance business
- the potential need for customer incentives, *eg* to save towards retirement.

Life insurance products could be more or less attractive than equivalent products offered by other types of financial institution, if those are subject to different tax rules.

Life insurance product design is influenced by the tax environment, *eg* adding an extra benefit or feature in order to receive favourable tax treatment.

Policyholder taxation

The tax treatment of the following should be considered in relation to policyholders:

- **premiums paid**
  - no tax relief – paid out of post-tax earnings
  - tax relief – earnings are taxed after deduction of premiums
  - possibly additional direct tax – although less common for life insurance
- **investment earnings**
  - gross roll-up – no tax deducted
  - subject to taxation – possibly after deduction of company's expenses
- **benefits received**
  - no tax, partially or fully taxed – possibly after deduction of premiums paid
  - if taxed, could be at the marginal income tax rate, excess of marginal rate over basic income tax rate, capital gains tax rate or a different specified rate.

Additional tax may be incurred in some situations, *eg* inheritance of the policy proceeds.

Tax advantages are generally restricted and care is taken not to be too generous overall.

Life insurance company taxation

The business needs to be classified into separate categories if different types of life insurance business are treated differently for tax purposes.

Taxation of profits

Trading profit = change in value of assets minus change in value of liabilities

= premiums + investment returns – claims – expenses – increase in liabilities

Tax rate is normally the corporation tax rate applying to profits arising in any company.

May be possible to offset losses against taxable profits in other years or group entities, subject to restrictions.

Mutual: taxable amount is zero.

Taxation of 'I-E'

I represents investment earnings, possibly excluding dividend income and/or unrealised gains on equities and property.

E represents expenses, possibly with the spread of acquisition expenses over a stated period.

If a **proprietary**, may be subject to the **minimum profits test:**

- minimum profit = trading profit with possible adjustments (*eg* minimum of zero)
- taxable amount is the higher of *I-E* and minimum profit
- taxable amount is split into shareholder profit and policyholder profit.

Shareholder profit = minimum profit: typically taxed at the corporation tax rate.

Policyholder profit = any excess of *I-E* over minimum profit: taxed at the 'policyholder tax rate' *eg* basic rate of income tax.

If minimum profit exceeds *I-E* (*ie* the minimum profits test bites), may be able to carry forward the unrelieved expenses (XSE) to include within *E* in the next year's tax calculation.

A company may become temporarily XSE due to various events, such as significant falls in the market value of bonds, being newly established with heavy expenses, or a material weakening of the liability valuation basis.

In a **mutual**, there is no shareholder profit and XSE is generated when $E > I$.

Taxation of premium income

Premium-based tax is a type of sales tax, more commonly used for short-term insurers and health business.

Tax rates may differ according to whether the insurer is domestic or foreign.

Simple to process but more onerous for higher premium business.

Chapter 6 Practice Questions

6.1 The taxation of two unit-linked products, from the policyholder's perspective, is as follows:

Product A
- Purchased from post-tax income with no tax relief on premiums
- Investment return accrues gross of tax
- The excess of benefits received over premiums paid is taxed at the policyholder's full rate of income tax

Product B
- Purchased from pre-tax income, thereby receiving tax relief on premiums
- Investment return accrues gross of tax
- Benefits received are taxed at the policyholder's full rate of income tax

Explain why the taxation of Product B might be preferable for a policyholder, compared with the approach taken for Product A.

6.2 Explain why a life insurance company with separate with-profits and without-profits long-term business funds needs to be careful when allocating the overall tax charges (or credits) to such funds.

6.3 A proprietary life insurance company that is subject to the '*I-E*' taxation approach is currently 'excess *E'* as a result of the minimum profits test.

(i) Explain the purpose of the minimum profits test.

(ii) State two circumstances that may cause an established proprietary life insurance company to become temporarily 'excess *E'* as a result of the minimum profits test, explaining in each case why that circumstance may bring this about.

6.4 A mutual life insurer is subject to '*I-E*' taxation, with dividends being excluded from taxable *I*.

Calculate the tax payable by the mutual in the following circumstances, and any XSE where applicable, assuming:

- basic income tax rate ('policyholder tax rate') = 20%
- corporation tax rate = 25%.

(i) $I = 300$; $E = 200$

(ii) $I = 300$ plus dividends received = 50; $E = 200$

(iii) $I = 200$; $E = 300$

(iv) $I = 140$ plus dividends received = 50; $E = 200$

6.5 Life insurance companies in Countries X and Y are subject to the '*I-E*' taxation approach, including the minimum profits test.

In both countries, the minimum profit amount is restricted to have a minimum of zero. Trading losses can be carried forward to reduce future profits.

In Country X there is no restriction on this carry forward, but in Country Y only 50% of losses can be used in this way.

Explain whether companies are more likely to be XSE in Country X or Country Y, all else being equal.

6.6 In a particular jurisdiction, all life insurance business is currently taxed on an '*I-E*' basis.

Exam style

Many insurers sell both protection and savings business, but there are some specialist companies that offer only term assurance contracts. These companies have been lobbying the government to change the tax approach for term assurance business. They state that this will enable them to compete more fairly with the generalist insurers who sell both protection and savings business.

(i) Explain whether term assurance business would be expected to be XSE or XSI, on a standalone basis. [2]

(ii) Explain why the specialist companies are lobbying for this change. [5]

[Total 7]

6.7 A life insurance company currently markets a unit-linked regular savings policy. The policy is predominantly sold through financial advisers.

Exam style

In line with the rest of the market, it has the following charging structure:

- a low percentage allocation in year one
- a level percentage (less than 100%) allocation in year two and onwards
- a bid/offer spread
- 1% *pa* annual management charge.

A surrender penalty is charged during the first ten years and is a percentage of the unpaid premiums up to the tenth policy anniversary.

The company is taxed on an '*I-E*' basis.

This charging structure exactly meets the shareholders' required profit margin.

The government wishes to encourage savings. It will allow unit-linked savings policies to be sold where the gross investment return can be passed to the policyholder tax-free. All proceeds of the policy will be free of tax in the hands of the policyholder. The taxation basis of the life company will no longer allow relief on the expenses of this business. To ensure value for money, the only charge permissible will be the annual management charge, which will be capped at 1% *pa*.

Discuss the impact of the proposals on the company and the options open to it in the light of the government initiative. [15]

Chapter 6 Solutions

6.1 ***Comparison of taxation approaches***

Under a unit-linked product, the benefit received can be considered to comprise the following:

Benefit = total premiums paid + investment earnings – charges
+ any additional benefit in excess of the unit fund (*eg* guarantee)

Under Product A, 'total premiums paid' has effectively incurred tax at the income tax rate applicable when the income used to pay those premiums was earned. The remainder is taxed at the income tax rate applicable when the benefit is received.

Under Product B, all of these components are taxed at the income tax rate applicable when the benefit is received.

Product B is therefore preferable from a taxation perspective if the policyholder is subject to a lower income tax rate in future, when the benefits are taken.

For example, this could be the case if the product is being used to fund for retirement, as income is generally lower in retirement than when employed and so the individual could move to a lower tax band.

Alternatively, it could be the case if income tax rates are expected to go down in future. For example, they may be temporarily high due to a significant government funding shortfall.

Product B could also be favourable if it encourages larger premiums to be paid (since they are paid from pre-tax rather than post-tax earnings), where this has advantages for the policyholder such as gaining a higher allocation rate.

6.2 Tax would normally be calculated at overall company level, not at long-term business fund level. There would therefore be no definitive apportionment of tax charges (or credits) between the two funds; the company has to use its judgement to decide how much tax to charge (or credit) to each.

With-profits funds are normally mostly (*eg* 90%), or even fully, policyholder-owned. In contrast, without-profits funds are normally 100% shareholder-owned.

Therefore, any tax charges (or credits) that are made to the with-profits fund will be mainly (*eg* 90%) passed on to the with-profits policyholders, through lower (or higher) bonuses.

In relation to the without-profits fund, if actual tax charged is higher (or lower) than has been priced for within the products written in that fund, it is the shareholders who will suffer (or benefit) from that difference.

It is therefore very important that the company takes a fair approach to deciding how much of the overall tax charges (or credits) to allocate to such funds, as this determines the proportion that is borne by shareholders *vs* policyholders.

6.3 (i) ***Minimum profits test***

The minimum profits test basically means that the company is taxed on the higher of *I-E* and an amount that represents the accounting or trading profit, after adjustment for certain items.

This ensures that proprietary life insurance companies pay a minimum amount of tax each year that is consistent with the taxation of any other type of trading company, *ie* corporation tax on trading profits.

(ii) ***Circumstances for becoming 'excess E' as a result of the minimum profits test***

1. *A weakening of the valuation basis used*

On non-participating business, this increases taxable profit because the profit calculation is in essence $P - C + I - E - (V_1 - V_0)$ and so a lower V_1 increases profit.

Therefore *I-E* is unchanged whilst profits are higher, so it is more likely that the minimum profits test bites.

2. *Significant capital falls in the bond market*

In particular, a situation where the net return from bonds is negative.

The change in value of the bonds is likely to be included in the *I-E* calculation. In this case, *I* will be reduced as a result of the negative returns and hence *I-E* will be reduced.

If the bonds are being held as matching assets for the liabilities, then in the minimum profits calculation, the reduction in *I* is likely to be more or less offset by a reduction in the liabilities. This is because as the prices of bonds fall, the valuation discount rate used to calculate the technical provisions will increase, and so the value of the liabilities will fall. So profits may remain broadly unchanged.

Hence, *I-E* is likely to reduce by more than profits.

It may also be the case that total *I* could be negative in the given scenario, or at least smaller than *E*, so that $I-E < 0$. If the minimum profit used in the test is restricted to be at least zero, then the minimum profits test will automatically bite in this situation.

6.4 (i) Tax = $(300 - 200) \times 20\% = 20$

(ii) Tax = $(300 - 200) \times 20\% = 20$ (The dividend income does not generate any further tax.)

(iii) Tax = 0, since $E > I$

XSE = 100 (300 – 200) carried forward to next year's *E.*

(iv) Tax = 0, since $E > I$

XSE = 60 (200 – 140) carried forward to next year's *E.*

The corporation tax rate is not applicable to a mutual.

6.5 All else being equal, companies are more likely to be XSE in Country Y. This is because the adjusted trading profits, after offsetting carried-forward losses, are likely to be higher in Country Y. In Country X, more of the profits can be offset by losses carried forward.

Higher trading profits means higher 'minimum profit', therefore it is more likely that the minimum profits test bites – and so more companies are likely to be XSE.

6.6 (i) *Term assurance business*

Term assurance business would typically have:

- relatively high *E*, *eg* underwriting costs, possibly also high commission [1]
- relatively low *I*, due to having small reserves that are typically invested in low risk / low return assets. [1]

Therefore would expect $E > I$ for this business on a standalone basis, and hence XSE. [1]
[Maximum 2]

(ii) *Fair competition between specialist and generalist insurers*

As indicated above, specialist insurers who write only term assurance business will most likely be XSE. [½]

Although this means that they do not have to pay any tax, nor are they able to gain tax relief for the expenses incurred on the term assurance business. [1]

The unrelieved expenses (XSE) can be carried forward into a future tax year, but if the insurer continues to write only term assurance business then this XSE can never be utilised. [½]

The generalist insurers also write savings business, which would be expected to be XSI on a standalone basis, generating higher *I* (due to holding larger reserves) and lower *E* (*eg* no underwriting costs). [1]

Hence the generalist insurers are able to use the excess *E* on term assurance business to offset *I* arising on savings business. [½]

They are therefore obtaining tax relief on all expenses incurred. [½]

When pricing the term assurance business, the specialist insurers would have to assume gross (of tax) investment returns and gross expenses. The generalists can assume net (of tax) investment return and net expenses. [1]

Since expenses are a more significant component of term assurance premium rates than investment return, the generalists will be able to charge a lower premium for the same level of profit. [1]

This makes the generalist companies more competitive in the term assurance market than the specialists. [½]

The specialists are therefore lobbying for a change in tax approach, ideally one that would result in the same level of tax to be taken from term assurance business irrespective of the other types of product offered within an insurer. [½]

For example, tax based on profits arising on term assurance business would achieve this. [½]
[Maximum 5]

6.7 *Running through all the areas of work of a life company will help in generating a wide range of ideas for the ways in which the proposal may affect the company. One way to reduce the risk of 'missing' an option available to the company is to be completely systematic about the four possible combinations of selling / not selling the existing and new contracts*.

Impact on company

The results of being taxed on this 'gross *I*' basis will be higher investment return (which will mostly be passed on to policyholders) and the loss of tax relief on the company's expenses. [1]

Savings policies are expected to generate higher *I* than *E*, therefore the higher investment return is more important. [½]

However, the loss of tax relief on the company's expenses will reduce profits, particularly as the company is unable to increase charges to cover the gross rather than net expense amounts. [1]

The effect of the cap on management charges will be a reduction in charges under the contract. The product has a 1% *pa* annual management charge (the maximum amount) and neither the reduced allocation rates nor the surrender penalty would be allowed as these are additional charges. [1]

The higher (untaxed) investment returns will lead to higher annual management charges to some extent, but this impact would be relatively small and unlikely to compensate for the removal of the other charges. [1]

The changes in policyholder taxation and reduced charges would make the new product more attractive to policyholders, particularly to higher-rate taxpayers. [1]

This would affect the company through changes in new business volumes and mix (and hence capital requirements) and changes to marketing strategy might also be necessary. The marketing may tie in with any promotion being undertaken by the government to encourage saving. [1]

The removal of the surrender penalty would be expected to lead to higher rates of withdrawal, which are especially important for regular premium contracts since future premium income is lost. [1]

Withdrawal rates may also change in response to any changes in the types of customer buying these contracts. Changed withdrawal rates would affect a wide range of areas, *eg* pricing, reserving and embedded value calculations. [1]

Options available to the company

1. *Stop selling the existing contract, sell the new contract* [½]

Taking this option will make the company very dependent on the success of its new contract, assuming the contract is a significant source of profit for it. [½]

The company is vulnerable to the risk of tampering with or removal of the new rules by the current, or future, governments. [½]

The new contract design will clearly be constrained by the new rules, *eg* the surrender penalty and reduced allocation rates will no longer be allowable. [½]

The maximum annual management charge will reduce the profit per policy that the company can actually achieve on these policies, *ie* the company cannot simply set the charge at a level such that it meets its profit criterion. [½]

Indeed, the contracts may not be profitable at all given the maximum charge. [½]

If still profitable, the volumes required to achieve the same total profit will be greater. [½]

The company might have to do significant marketing to achieve sufficient volumes of sales. [½]

Even if a successful promotion is run by the government and take-up of the new type of savings product is high, the company will want to advertise to achieve the market share that will be necessary to justify the high levels of investment and risk involved. [½]

Having just a management charge may make only policies above a certain minimum size sufficiently profitable, as a 1% *pa* charge from a small policy may be insufficient to recoup even the fixed per-policy expenses. [½]

So a higher level of minimum premium than on the existing contracts might be imposed. [½]

The company may need to look for ways to reduce its per-policy expenses. [½]

It may consider moving to different, potentially cheaper, distribution channels. [½]

However, this would be likely to upset the current advisers and the effects of this on other areas of the company's business should be taken into account. [½]

On the other hand, the company may accept smaller policies in an attempt to spread costs and accept a reduced contribution from these policies. [½]

The experience of the new contract may differ significantly from that of the existing contract, *eg* due to a different target market and average policy size. Care should be taken in setting new best estimate assumptions for pricing, embedded value reporting, Solvency II reporting *etc*. [1]

There is also more uncertainty attached to the future experience and so the company may wish to make more prudent assumptions and/or set a higher profit criterion in its pricing. [½]

The company will need to consider whether to improve terms for existing customers with an old-style policy, particularly to avoid the risk of lapse and re-entry. [1]

2. *Sell both the existing and the new contract* [½]

Since the new policy will produce better returns for the policyholder, Option 2 will only be viable if the new policy has limited availability (*eg* a high minimum premium) or limited flexibility (*eg* narrower choice of unit-linked funds or fewer free switches). [1]

The issues with the new contract are as for Option 1, although in this case the company is no longer quite so dependent on the success of the new contract. [½]

There may be selling issues in offering both types of policy – especially if both are sold predominantly through the same financial adviser channel. It may be difficult to demonstrate that all customers have been offered the most appropriate product. [1]

Continuing to sell both types of contract raises the issue of advising customers to switch between them if this is appropriate. It may be that the choice of the more appropriate contract for a particular customer varies during the life of the contract, for example if a premium increase makes the customer eligible for the new product. [1]

3. *Continue selling the existing contract, do not sell the new contract* [½]

In doing this, the company misses out on the success or failure of the new type of contract, at least initially. [½]

If the new type of contract is unsuccessful or unprofitable then this will be a good thing. [½]

If the new style of contract is a success and the company tries to enter the market at a later date it may find it difficult to pick up sufficient market share from existing competitors. [½]

By not selling the new contract, the company avoids the development costs and any systems changes for the new product, *eg* to the tax calculation system and valuation system. [½]

The company is on more certain ground by continuing to sell its current product but must consider the changed environment before choosing this option. For example:

- The company should consider whether there will still be a market for the existing product. This will be affected by any government advertising. [1]
- There is a risk of policyholders surrendering and taking out new contracts elsewhere. This will affect surrender rates, per-policy expenses and profits of the company. [1]

4. *Sell neither contract* [½]

The company may take the drastic step of withdrawing from the unit-linked regular savings market. [½]

In this case, the company should consider carefully its future strategy. Will it specialise in another (existing or new) market? How sure is it that this other market's future is secure? [1]

The company will need to consider its treatment of the current in-force policyholders. As with Option 3, there is a risk of existing policyholders surrendering. [½]

[Maximum 15]

7

Taxation (2)

Syllabus objective

2.2 Explain the general principles of the taxation of life insurance business from the perspective of:

- governments
- policyholders
- life insurance companies.

0 Introduction

The previous chapter provided some general comments about the principles of life insurance taxation. It is useful to see the approach actually taken in some countries.

Life insurance company taxation can be extremely complex in practice. The following sections provide a very high level overview of some of the features of the taxation approach in particular jurisdictions. This is not intended to be exhaustive.

The '*I-E*' system and the 'five funds' system (as described below for South Africa) are relatively rare, with more countries (*eg* most of continental Europe) taxing on a gross roll-up basis.

In other words, most countries have a taxation approach that allows investment earnings to accumulate within the life insurance company without being taxed, but the companies are then (typically) taxed on profits arising (or, in some cases, on premium income).

As described below, the '*I-E*' system is used for some business in the UK and (historically) Ireland. The UK model was adopted by some other countries, such as India, but with adaptations that have evolved to suit the local market.

Students are not expected to know the detail in this chapter but the principles highlighted could be examinable.

The following sections outline the key features of taxation in the UK and then in a number of other jurisdictions.

1 United Kingdom

1.1 Classification of business

In the UK life insurance business has to be split between two tax categories:

- **Basic Life Assurance and General Annuity Business (BLAGAB), mainly comprising life assurance savings, plus general (non-pension) annuities and some historic protection business**
- **Non-BLAGAB business, mainly comprising pensions business, other tax-advantaged products, more recent protection business, income protection insurance and overseas business.**

'General annuities' are annuities that are not purchased using the proceeds of (tax-advantaged) pension arrangements, but which are simply purchased using the individual's savings that have accrued from taxed income.

For UK tax purposes, 'protection business' is broadly defined as a life insurance contract under which the benefit payable cannot exceed the amount of premiums paid except on death or disability / sickness. Therefore it would include standard term assurance and critical illness business, but not endowment assurance or whole life assurance savings contracts where significant surrender or maturity values can accrue.

Up until 1 January 2013, UK protection business was taxed as BLAGAB, using an '*I-E*' basis – as will be explained later in this section. After that point, new protection business has been taxed as non-BLAGAB business, on profits. This change was principally driven by the reasons that were explored in one of the practice questions at the end of the previous chapter.

'Other tax-advantaged products' that are included in non-BLAGAB business include tax-exempt savings schemes, for example those that are set up as savings funds for children.

The 'overseas business' referred to as part of non-BLAGAB business means policies that are written on the lives of policyholders who live in other countries.

If a company has only an immaterial amount of BLAGAB business, it would be taxed wholly on a non-BLAGAB basis.

Investment returns on BLAGAB unit-linked business are also separately identified from the rest of BLAGAB investment returns.

1.2 Policyholder taxation

The following gives some examples of how the main types of UK life insurance business are taxed from the policyholder's perspective.

Term assurance and critical illness insurance

Premiums

Premiums are payable from post-tax earnings.

(Investment earnings are immaterial for such business.)

Benefits

Benefits are not taxed.

Life assurance savings products

For example, endowment and whole life assurances.

Premiums

Premiums are payable from post-tax earnings.

Investment earnings

Investment earnings that accumulate within the policy are taxed within the life insurance company, after the deduction of 'expenses', at the basic rate of income tax.

This is because the insurance company is taxed on an '*I-E*' basis for this type of business (as described in the next section), so the *I* suffers tax at the basic rate within the insurer.

The basic rate of income tax in the UK is 20% (May 2022).

Benefits

Tax may be payable on the excess of the benefit received over the premiums paid, although this is not necessarily the case on death, maturity or late surrender, depending on the precise product.

There are some policies, classed as 'qualifying policies', where tax is not payable on death, maturity or surrender at late durations. However, such policies are now less commonly sold due to the restrictions imposed (*eg* relatively low maximum premium).

As was noted in the previous chapter, the excess of benefit received over premiums paid may be referred to as the 'chargeable gain', being the amount on which tax is normally charged.

Where tax is payable, the rate used is the excess of the policyholder's marginal tax rate over the basic rate of income tax.

At the time of writing (May 2022), the UK marginal income tax rates could be 20%, 40% or 45%, so the rate of tax used would be 0%, 20% or 25% respectively.

This tax is therefore only payable on benefits from these products by policyholders whose marginal tax rate is higher than the basic tax rate.

No tax would be payable by basic-rate taxpayers or by those who do not pay income tax.

Question

Explain who might find 'qualifying policies' most advantageous.

Solution

Individuals who pay tax in one of the higher income tax bands, above the basic income tax level.

This is because they would not pay any tax on death, maturity or late surrender benefits under a qualifying policy, but would under a non-qualifying policy.

Individuals who pay income tax at the basic rate, or who do not pay any income tax, would not pay any tax on benefits whether the policy was qualifying or non-qualifying.

General annuities

These are also known as 'purchased life annuities'.

Premiums

Premiums are payable from post-tax earnings.

Investment earnings

Investment earnings: as for life assurance savings products.

Benefits

Tax is payable on part of the benefit received, at the policyholder's full marginal tax rate.

Each annuity payment received by the policyholder comprises a return of part of the policyholder's premium (the capital content), and part is in economic terms interest (the income content).

The return of premium element of the payment is free of UK income taxation.

The remaining proportion of each payment is subject to taxation as income.

In broad terms, the return of premium element is obtained by dividing the purchase price of the annuity by the individual's life expectation, where this is determined according to prescribed mortality tables.

So effectively the premium is returned to the annuitant tax-free, but tax has to be paid at their full income tax rate on the balance of each annuity payment.

Question

A UK 40% taxpayer receives an annuity with an income content of £300.

The gross (pre-tax) amount of the annuity is £1,000.

Calculate the net (post-tax) annuity amount.

Solution

(£1,000 – £300) + £300 × 0.6 = £880

Pensions products

The UK pension taxation system is described as having an 'EET' basis (Exempt contributions, Exempt investment return, Tax on access to benefits).

Premiums

Premiums obtain tax relief, subject to limits.

These limits include a maximum tax-free contribution of the lower of £40,000 (May 2022) and the individual's full taxable earnings.

Investment earnings

Investment earnings accumulate free of taxation, subject to some restrictions.

For example, any investment in residential property, wine or antiques would not qualify for inclusion in this gross roll-up approach.

Benefits

25% of the accumulated fund value may be taken as a tax-free lump sum once retirement benefits start to be taken, but all subsequent pension benefit payments are added to the policyholder's earned income. Consequently, the benefit payments in future years are taxed at the individual's marginal tax rate each year.

This applies whether the remainder is taken as an annuity, as withdrawals from an income drawdown product or as cash (where permitted).

To the extent that they cause the policyholder to be taxed at a higher rate, they are taxed at that higher rate.

If the pension benefit causes the individual's total income to move into a higher income tax band, that part falling within that band would be taxed at the higher rate.

A higher tax rate would also be applied to the extent that the accumulated pension fund value exceeds a specified 'lifetime allowance' amount.

This 'lifetime allowance' is £1.073*m* for the 2022/23 tax year (May 2022). The additional tax charge applies to any accumulated pension funds in excess of this allowance, whether these are taken as cash, income drawdown or an annuity. The overall tax rate applied currently exceeds the marginal rate in the highest income tax band.

A further higher specified tax rate may also be payable on death benefits from income drawdown products.

Question

Outline the tax that would be payable by a UK 45% taxpayer on benefits arising from each of the following policies:

(i) term assurance

(ii) endowment assurance (non-qualifying)

(iii) general annuity

(iv) personal pension.

Solution

(i) Nil (the death benefits are not taxed).

(ii) 25% (= marginal rate of 45% minus basic rate of 20%) of the excess of benefits received over premiums paid.

(iii) 45% of the income component of each annuity (which represents the excess of the annuity benefit over the gradual return of premium).

(iv) Nil on 25% of the accumulated pension fund, 45% on the remainder (or a higher tax rate if the lifetime allowance is breached or on death benefits from income drawdown).

1.3 Life insurance company taxation

Apportionment between tax funds

Because BLAGAB and non-BLAGAB are taxed differently, it is necessary to divide the company's trading profits and *I* minus *E* (investment income and gains less expenses) between the two categories.

In some cases, this is very clear (such as with linked business, or premiums and claims) but in other cases an apportionment is necessary (*eg* assets which are not segregated between life and pension business, or surplus assets).

In other words, profits, investment income, capital gains and expenses each have to be separated between those items which are to be treated as BLAGAB and those which are to be treated as non-BLAGAB.

UK tax legislation provides principles that set out how this should be done. For example, if the company matches its annuities with bonds, then the tax authorities would expect the investment return from the bonds to be allocated to the annuities for taxation purposes.

Tax calculations are more straightforward for companies where the life assurance savings and pension assets of the life company are clearly segregated, such as might be the case for purely unit-linked business. In other cases, such as a with-profits company, the assets may be managed together and so need to be apportioned for the purposes of the tax calculations.

Non-BLAGAB

Non-BLAGAB business is taxed in the same way as the profits of any UK trading company.

This reflects a government aim of the taxation system being broadly equivalent across all companies.

That is, it is liable to corporation tax on the pre-tax trading profits according to the entity Companies Act accounts. These accounts may be prepared in accordance with IFRS or in accordance with UK GAAP.

The Companies Act accounts are the published accounts that are prepared by all UK trading companies. The current (as from April 2022) full corporation tax rate in the UK is 19%. This is due to increase to 25% from April 2023.

Accounting losses can be used to offset profits in other tax years or in other companies within the group, subject to some restrictions.

BLAGAB

BLAGAB business is taxed on the *I* minus *E* basis that was described in the previous chapter, including the application of the minimum profits test.

Under the UK minimum profits test:

- the shareholder share of dividends received is excluded from the minimum profit calculation (since dividend income is not included in *I*-*E*, against which the adjusted trading profit is compared)
- the minimum taxable amount is restricted to be no less than zero (with losses carried forward, subject to restrictions).

The shareholder profit part of the taxable amount is taxed at the corporation tax rate (25% from April 2023) and the policyholder profit part is taxed at the basic rate of income tax (20%).

The UK approach to the determination of *I* and *E* is set out below.

***I* includes:**

- **all investment income other than dividend income from equities**
- **realised chargeable gains on equities and property, with some historical allowance for indexation**

  In the UK, the indexation that applies to chargeable gains on equities and property is based on the Retail Prices Index (RPI). However, no indexation can be taken into account on gains earned from the beginning of 2018 (although indexation up to the end of 2017 can still be taken into account).

- **unrealised chargeable gains on collective investment schemes holding equities and property (spread over 7 years)**

  It might have been expected that a life insurance company would only pay tax on capital gains on its holdings in such schemes when it sold the units concerned. However, some companies abused this treatment (*eg* by investing much or all of their free assets in unit trusts) and so the above rule was introduced.

- **mark-to-market (or mark-to-model) capital movements in gilts, bonds and most derivatives**

  This means that gilts (UK government bonds) are taxed on their total return (*ie* income plus capital movements) over the year, with no indexation of capital movements on fixed-interest securities. Index-linked securities, however, *do* receive the benefit of indexation of capital gains.

  The capital movements in gilts and bonds are taken on a mark-to-market basis, *ie* any gains or losses for a year are determined using start- and end-year market prices (or the prices at which the securities were traded if bought or sold during the year).

  Example

  Consider a two-year zero-coupon bond, bought for £18,000 and redeemed for £20,000.

  If the bond has a market value of £19,300, say, at the end of the first year, then gains of £1,300 and £700 respectively will be recognised in the two years.

  However, if the market value fell to £17,800 at the end of the first year (perhaps due to concerns over default risk) a loss of £200 would be recognised. If the issuer goes on to redeem the bond at the end of year two, then a subsequent gain of £2,200 will be recognised.

Question

A UK tax fund that holds only equities receives the following investment earnings:

- dividends of 100
- realised gains of 50, which are subject to an indexation deduction of 30
- unrealised gains of 40, which are subject to indexation of 15.

Determine the total value allocated to investment return that appears in the final tax assessment if the fund is:

(i) BLAGAB and the minimum profits test does not bite

(ii) non-BLAGAB.

Solution

(i) 50 – 30 = 20 since the minimum profits test does not bite and so is taxed on *I-E*

(ii) 100 + 50 + 40 = 190

***E* includes:**

- **expenses, with acquisition expenses being spread over 7 years**

  Acquisition expenses refers to all expenses that relate to the acquisition of new business, including all commission payments – even renewal commission.

- **the income component of general annuities, reflecting the fact that this is taxed in the hands of the policyholder**

  As mentioned in the previous section, the income component of general annuities is taxed at the policyholder's full marginal rate, with no deduction for basic-rate tax. Hence it is deducted from the company's *I-E* calculation in order to avoid being taxed twice.

- **the carry forward of any XSE from the previous year (where applicable).**

  As described in the previous chapter, this happens when the company is in an XSE position in the previous tax year, typically as a result of the minimum profits test biting.

A particular year's BLAGAB expense deductions are therefore made up of:

- non-acquisition BLAGAB expenses from that year
- 1/7 of acquisition BLAGAB expenses from that year
- postponed acquisition expenses from previous years, *ie* 1/7 of previous acquisition expenses from last year, the year before, the year before that ...
- the income component of general annuity business
- where relevant, any unrelieved expenses (XSE) brought forward.

Question

Show that a UK proprietary life insurance company effectively pays tax on shareholder trading profit for general annuity business, whether the company is XSI or XSE.

Solution

If the company is XSI, it will pay tax on *I-E*.

For a general annuity contract, $E = E' + IC$ (where E' = expenses and IC = income component of general annuity).

Broadly, $IC = C - P$ (where C is the annuity benefit and P represents the annuity premium, which is spread across the annuitant's expectation of life).

Using the approach as set out in the previous chapter and considering the position over the full lifetime of the general annuity policy:

$$I - E = P - C + I - E + C - P$$

$$= P - C + I - E' - IC + C - P$$

$$= P - C + I - E' - (C - P) + C - P$$

$$= P - C + I - E'$$

= Shareholder profit

If the company is XSE, then by definition the minimum profits test is biting and so the taxable amount is based on (shareholder) trading profit.

Deferred tax liabilities

Because capital gains on directly-held equities and property are not taxed until they are realised, it is necessary for the life insurance company to hold deferred tax liabilities in respect of the accrued liability to tax on the unrealised gains to date. Allowance for deferred tax is also required for amounts spread over 7 years.

The deferred tax liability would normally be determined as the value of the accrued tax charge on the taxable unrealised gains to date, discounted back from the time at which those gains are expected to be realised and hence the tax has to be paid (and similarly for other spread amounts).

Such deferred tax liabilities are relevant to:

- **balance sheets for statutory or supervisory reporting**
- **unit pricing, to ensure that the basic equity principle of unit pricing is met**
- **the determination of asset shares, also to ensure fairness between policyholders.**

Question

Deferred tax liabilities in respect of unrealised gains on equities and properties should be included in unit pricing and asset share calculations for BLAGAB business in order to ensure the fair treatment of unit-linked and with-profits policyholders.

Explain the above statement.

Solution

Unit pricing

The basic principle of equity in unit pricing states that the interests of unitholders not involved in a unit transaction should be unaffected by that transaction.

Tax on capital gains is not payable until the equities or properties are actually sold, for example due to a large amount of withdrawals from the fund.

Consider an individual who has benefitted from an increase in unit fund value due to the unrealised gains on those assets. The company might hold the assets for many years after that policyholder has left the fund. For the basic equity principle to hold, that individual should pay a fair amount of the tax due on the gains in which they have participated. This is done by adjusting the unit price to allow for the tax as it accrues, not just when it is paid.

Hence an individual who leaves immediately before tax is paid on the realised gains and one who leaves immediately after will be treated consistently and fairly.

With-profits asset shares

Similarly, the deferred tax liability will be deducted from asset shares to ensure that each with-profits policyholder is being charged a fair share of the accrued tax liability on the unrealised capital gains from which they have benefitted.

The calculation of asset shares is considered in more detail in a later chapter.

Similarly, it might be possible to hold a deferred tax asset to reflect the potential value of any realised or unrealised loss, which could be used to offset future gains and therefore reduce a future tax payment.

Question

Outline the key variables on which a deferred tax liability (or asset) established within a BLAGAB internal linked equities fund would depend.

Solution

The key variables would be:

- the size of the unrealised capital gain (or realised / unrealised loss) on the equities to date, allowing for any historical indexation where appropriate
- the time until the unrealised gains (or losses) will be realised, which will depend on:
  - how actively the investments are being managed (the more active, the shorter the expected time until the assets are sold)
  - whether the units are being priced on a bid or offer basis (a fund pricing on a bid basis is likely to be contracting, so the expected time until realisation is shorter as the company will have to start selling assets in order to pay the net cash outflows)
- for losses only, the additional time until a realised loss can be offset against a realised gain
- the future tax rate that will apply at the time of realisation
- the discount rate, typically based on the expected return (net of tax) on the assets held in the fund.

2 Other jurisdictions

2.1 Ireland

Classification of business

In Ireland, life assurance business is categorised into:

- **'old basis business', written before 1 January 2001 – which receives a similar tax treatment to UK BLAGAB business**
- **'new basis business', written on or after 1 January 2001 – which is taxed on a gross roll-up basis.**

Policyholder taxation

For 'new basis business', the investments are allowed to accumulate tax-free within the life insurance company until a chargeable event occurs (*eg* death, surrender or maturity). At that point, Life Assurance Exit Tax (LAET) is due on the gain made by the policyholder on the policy, *ie* the excess of the benefit received over the premiums paid. The LAET rate is specified and differs from income and capital gains tax rates. The tax amount due is deducted from the benefit paid by the life insurance company, which then pays it directly to the tax authority.

The current rates of exit tax (May 2022) are 41% for individual policyholders and 25% for corporate policyholders.

Pensions business is subject to separate taxation rules, with contributions receiving tax relief (subject to limits) and benefits being taxed as income.

Life insurance company taxation

Under the 'old basis business', the shareholder profit component is taxed at the standard rate of corporation tax (12.5% at May 2022) and the policyholder component is taxed at the standard rate of income tax (20% at May 2022).

The 'new basis business' is taxed on profits at the corporation tax rate.

2.2 USA

Policyholder taxation

In the USA, life insurance business generally benefits from the gross roll-up of investment earnings.

Death benefits from life assurance products are generally not taxable. However, on surrender or withdrawal, the excess of the cash amount received over premiums paid is taxable as income.

To avoid abuse of the tax-advantaged investment roll-up, this deduction of premiums paid is removed if too many premiums are paid into the policy over too short a period of time.

Many insurers took advantage of the tax-free growth of these policies by offering products with substantial 'cash value' (*ie* surrender value) growth potential. Policyholders could access this cash value by taking out a tax-free loan against the still-in-force policy. In this way, they were accessing significant tax-sheltered investments – so the tax authorities responded by restricting the amount of premiums that could be accumulated under such policies. Policies that have breached the limits are re-classified as modified endowments, as was mentioned in an earlier chapter.

Contributions to retirement products such as 401(k) plans are made from pre-tax earnings, so gain tax relief. The benefits from these plans are taxable as income.

This is similar to the tax rules that apply to UK pensions products.

Life insurance company taxation

The insurance company is taxed on profits at the normal corporation tax rate. In addition, tax is paid on premium income.

Different States have different premium tax rates.

In the USA, there are two main layers of legislation: federal (applying across the whole country) and State (or territory). This applies to taxation, so as well as federal tax there are also taxes set by each State.

Whilst corporate tax is payable only in the insurance company's home State, premium taxes are collected by every State in which the business is written.

The applicable rate is the higher of the premium tax rate in the insurer's home State and the premium tax rate that applies to the State in which the premium was written.

This helps to protect the market for 'domestic' insurers based in that State.

2.3 South Africa

Policyholder taxation

In general, premiums for life assurance products are paid out of post-tax earnings and do not qualify for tax relief, but benefits are not taxable (with some exceptions).

There may be a tax charge on benefits if these form part of an inherited amount.

Premiums paid into approved pension plans are subject to tax relief up to a defined limit. At retirement up to a third of the accumulated pension fund can be taken as a lump sum, which is partially taxable. The remainder, taken as an annuity, is taxed as income.

Policyholders are not taxed on the accumulation of investment earnings, as (where applicable) tax has already been paid by the life insurance company.

Life insurance company taxation

Life insurance companies are taxed using a 'five-fund approach'. The business is allocated into five categories, each of which is subject to different tax treatment:

- **individual policyholder fund – mostly individual life assurance savings and historic protection policies**
- **company policyholder fund – corporate policies**
- **untaxed policyholder fund – annuities, policies owned by retirement funds and other untaxed entities**
- **risk policy fund – more recent protection policies**
- **corporate fund – all other assets and liabilities.**

The accrual of investment return in the untaxed policyholder fund is tax-free. In the individual policyholder fund, a rate of tax is applied that is intended to represent an average policyholder income tax rate. The remainder are taxed at the corporate tax rate.

The current policyholder average tax rate used is 30% and the corporation tax rate is 28% (May 2022).

2.4 Australia

Classification of business

Business written by life insurance companies is split into categories so that the different types are taxed in line with the nearest equivalent of other financial instruments, in order to ensure consistency of approach.

So, for example:

- **protection business is taxed on a similar basis to general insurance**
- **savings business is taxed on a similar basis to investment companies**
- **superannuation (pensions) business is taxed in the same way as corporate superannuation funds.**

Policyholder taxation

Broadly speaking, contributions that relate to superannuation funds are tax deductible (taken from pre-tax income). Superannuation contributions incur an additional level of 'contributions tax' but, up to a specified level, this is rebated into the fund. Investment earnings within the superannuation fund are taxed, but benefits can be taken tax-free above a specified age.

Premiums for life insurance business that does not relate to superannuation are not tax-deductible, but death benefits are generally not taxed.

Life insurance company taxation

Life insurance company taxation in Australia is fairly complex, but broadly aims to tax life insurance companies' business in the same way as the equivalent business of general insurers, investment companies and corporate pension funds – as suggested above.

2.5 China

Policyholder taxation

Premiums for life insurance business are generally not tax deductible, but no tax is payable by policyholders on the accumulation of investment earnings or on benefits received.

Life insurance company taxation

Life insurance companies are taxed on profits at the corporate tax rate.

Until 2016, an additional 5% business tax was imposed on the premium income received by insurance companies. This was replaced by the inclusion of insurance premiums in the value added tax (VAT) system, which imposes a 6% VAT rate on the policyholder. However, life and health insurance that exceeds a one-year term is excluded from this VAT requirement (as was the case for the additional business tax).

This simple taxation approach reflects the relatively young nature of the life insurance industry in China.

In Hong Kong, life insurance companies are taxed not on profits but on an amount that relates to premium volumes.

2.6 'Offshore' business

The life insurance market operates across borders.

Certain centres have developed which attract customers from other countries, by offering tax advantages relative to the domestic life insurance markets. This is known as 'offshore' life insurance.

For example, offshore insurance locations in Europe include Luxembourg, Dublin (International Financial Services Centre), the Isle of Man and Guernsey.

The products offered are normally savings or investment-based, with customers typically being relatively wealthy, often expatriates.

An expatriate is someone who lives outside their country of citizenship, whether temporarily or permanently, often for work or in retirement.

3 Appendix: Example BLAGAB tax computations

XSI computation

This table is part of the Core Reading and is included as an example of how a set of UK BLAGAB tax computations might be presented. You would not be expected to understand the details of the calculation beyond what is included in the descriptions in the earlier sections of this chapter.

I-E computation	***£m***	***Notes***
Loan relationship income	**40**	**Mainly interest income, plus gains on bonds *etc***
Rental income	**20**	**Rental income**
Sundry income	**10**	***eg* taxable commissions**
Chargeable gains	**60**	**Includes realised gains on equities / properties, and 'spread gains' on unit trusts**
Minimum profits charge	**-**	**Nil here as trade profits are below *I-E* profits**
Less: Management expenses	**(50)**	**Expenses for the year, adjusted for spreading of acquisition expenses and disallowable expenses**
Total I-E taxable profits	***80***	***Sum of above***
Shareholder share of taxable profits	**32**	**See calculation below**
Policyholder share of taxable profits	**48**	**Remainder of taxable profits**
BLAGAB tax payable		
Tax on shareholder share	**6**	**Shareholder profits at 19% for FY18 (financial year 2018)**
Tax on policyholder profits	**10**	**Policyholder profits at 20% (basic rate of income tax)**
Total current tax charge for the year	***16***	***Sum of above***
Calculation 1 – BLAGAB trade profits		
Accounting profit / (loss)	**60**	**BLAGAB share of statutory profit / loss**
Policyholder current tax deduction	**(10)**	**As above**
Policyholder deferred tax deduction	**(20)**	**Movement in policyholder deferred tax**
Disallowable expenses / other tax adjustments	**5**	**Should largely match those reflected in management expenses above**
Transitional adjustment	**5**	**Run off of adjustment from changes in tax rules in 2013 (spread over ten years)**
BLAGAB trading profit / (loss)	***40***	***Sum of above***
Calculation 2 – shareholder share		
BLAGAB trade profit	**40**	
Less: shareholder non-taxable dividends	**(8)**	**Total BLAGAB non-taxable dividends of £30m at shareholder share of 25% – this is a formula**
Shareholder share of profits	***32***	***Sum of above***

Chapter 7 Summary

United Kingdom taxation framework

Tax fund	BLAGAB	Non-BLAGAB
Products included	Life assurance savings business, general annuities, historic protection business	Pensions business, other tax-advantaged products, income protection, overseas and more recent protection business
Policyholder taxation	**Life assurance savings** • no tax relief on premiums • investment earnings taxed at basic income tax rate • benefits in excess of premiums normally taxed at {marginal income tax rate – basic income tax rate} **General annuities** • as above for premiums and investment earnings • benefits in excess of capital content taxed at full marginal income tax rate **Protection**: see non-BLAGAB	**Pensions** • tax relief on premiums (with limits) • investment earnings tax-free • 25% of benefits tax-free, rest taxed at marginal income tax rate (or higher) **Protection** • no tax relief on premiums • benefits tax-free
Life insurance company taxation	***I-E*** Subject to the minimum profits test (proprietaries only) *I* mainly comprises investment income (excluding dividends) and capital gains – but only when realised for equities and property (therefore deferred tax liabilities needed in reporting / unit pricing / asset shares) with some historic indexation allowed *E* comprises expenses (acquisition expenses are spread), income component of general annuities, brought forward XSE Shareholder share taxed at corporation tax rate; policyholder share at basic rate of income tax	**Trading profit** From the accounts Losses can be used to offset profits in other years / companies Taxed at corporation tax rate

Taxation in other jurisdictions

	Policyholder taxation	Life insurance company taxation
Ireland	'New basis business': • gross roll-up • non-pensions benefits (in excess of premiums) taxed at Life Assurance Exit Tax rate • pensions benefits taxed as income, with premiums receiving tax relief	'Old basis business': as for UK BLAGAB 'New basis business': as for UK non-BLAGAB
USA	• gross roll-up • life assurance death benefits tax-free (surrender benefits in excess of premiums taxed as income) • retirement product benefits taxed as income, with premiums receiving tax relief	Profits taxed at normal corporation tax rate Tax also paid on premium income, different States have different tax rates (may differ depending on whether domestic or out-of-State insurer)
South Africa	• gross roll-up • benefits generally not taxable for life assurance, and no tax relief on premiums • pension funds partially taxed on the first third, rest taxed as income, with premiums receiving tax relief up to a defined limit	'Five-fund approach' Individual policyholder fund: taxed at an average policyholder income tax rate Untaxed policyholder fund: investment accumulation tax-free Company policyholder fund, risk policy fund and corporate fund: taxed at corporation tax rate
Australia	• non-pensions: no tax relief on premiums but no tax paid on death benefits • superannuation (pensions): tax relief on premiums, investment earnings taxed, benefits tax-free above a certain age	Taxed as per nearest equivalent according to business type, *eg*: • protection business as general insurance • savings business as investment companies • superannuation business as corporate pension funds
China	• gross roll-up • no tax relief on premiums • benefits not taxable • VAT payable on premiums for short-term (one-year) policies	Mainland China: taxed on profits at the corporation tax rate Hong Kong: taxed on premium volumes

Chapter 7 Practice Questions

7.1 Compare how a UK policyholder may be taxed on receipt of benefits arising from the following:

- life assurance savings contract
- general annuity contract.

7.2 The following figures apply to a UK proprietary life insurance company.

BLAGAB *I-E*	520
BLAGAB profit *	250
Non-BLAGAB profit	260

* No further adjustments are required to the BLAGAB profit.

Calculate the amount of tax payable, assuming that the policyholder tax rate is 20% and the corporation tax rate is 25%.

7.3 A UK proprietary life insurance company sells a full range of life assurance and pensions contracts.

Exam style

The following is an extract from its tax calculations for years X and X+1:

	Year X	Year X+1
	£*m*	£*m*
BLAGAB		
Taxable investment earnings	1,500	1,300
Allowable expenses	800	1,000
Accounting profit	400	350
Non-BLAGAB		
Accounting profit	(150)	450

The following information is also provided:

- the company was not XSE for year X–1
- there were no non-BLAGAB losses brought forward from year X–1
- the year X non-BLAGAB losses were carried forward to be offset against non-BLAGAB profits in year X+1 (but are not included in the above accounting profit for year X+1)
- the policyholder tax rate was 20% throughout the relevant period
- the corporation tax rate was 25% throughout the relevant period
- the company does not receive any dividend income.

Calculate the tax payable by the insurer in years X and X+1, including a brief explanation of each calculation. [7]

7.4 The mortality basis on which the general annuity capital content is calculated has been improved, *ie* it has become lighter.

Explain how this will impact a UK life insurance company's BLAGAB tax bill, all else being unchanged.

7.5 A UK life insurance company is running a slightly unusual internal linked BLAGAB fund, for which there is a single asset. The asset was purchased on 1 January 2015 for £2,000. The current quoted price of the asset is £3,000. The company expects the asset value to grow at 10% *pa* until it is sold in one year's time. It is expected to produce no income.

Calculate a possible allowance for deferred tax, assuming the indexation allowance was 3% *pa* throughout the period from asset purchase to year end 2017 and using a tax rate of 20%.

7.6 Suggest characteristics of life insurance business in each of the following jurisdictions, that would lead to the insurer paying a higher amount of tax:

(i) UK

(ii) Ireland

(iii) USA

(iv) South Africa

(v) China.

Chapter 7 Solutions

7.1 ***Similarities***

Where tax is payable under the life assurance savings contract, it is paid on the excess, if any, of the benefits received over the total amount paid in premiums.

For general annuity contracts, the annuitant is liable to tax on the amount of each annuity payment that exceeds the capital content.

Since the capital content basically represents the premium being gradually returned to the annuitant, these approaches are similar.

Differences

However, the amount of benefit taxed under a general annuity will only equal benefits received minus premium paid if the annuitant lives for the same number of years as their expectation of life as calculated at the commencement of the annuity using the mortality table set out in tax legislation.

A more significant difference is that policyholder tax is payable at different rates for the two types of contract.

For the life assurance savings contract, the tax rate used is the policyholder's marginal income tax rate less the basic rate of income tax.

For the general annuity contract, the tax rate applicable is the policyholder's full marginal income tax rate.

Another difference is that tax might not be payable on the benefits received from the life assurance savings contract. For example, benefits on death, maturity or late surrender might not be taxable, depending on the product.

7.2 $(260 + 250) \times 0.25 + (520 - 250) \times 0.20 = 181.5$

7.3 ***Tax calculation***

We will work in millions of pounds throughout the solution.

Year X

The taxable amount in the non-BLAGAB fund is set to zero since a loss has been made, so there is zero non-BLAGAB tax payable. [1]

As there are no unrelieved expenses brought forward from year X–1, we have:

Year X BLAGAB $I\text{-}E = 1{,}500 - 800 = 700$ [1]

The minimum profit is used to split the total taxable income in the *I-E* computation between shareholders and policyholders. [½]

The minimum profit is the accounting profit arising from the BLAGAB fund (there are no dividends so no adjustment is needed):

Year X minimum profit = 400 [½]

The minimum profit is taxable at the corporation tax rate, while any excess of the *I-E* computation over the minimum profit is taxed at the policyholder rate. [½]

So:

BLAGAB tax paid in year X = 25% on 400 + 20% on 300 = 100 + 60 = 160 [½]

Adding together the non-BLAGAB and BLAGAB tax gives total tax paid of:

Year X total tax paid = 0 + 160 = 160 [½]

Year X+1

The non-BLAGAB loss of 150 brought forward from year X can be offset against the non-BLAGAB profit in year X+1 (assuming that this is not subject to any restrictions). [½]

So:

Year X+1 non-BLAGAB taxable trading profit = 450 – 150 = 300 [½]

The non-BLAGAB trading profit is then taxed at the corporation rate:

Non-BLAGAB tax paid in year X+1 = 25% on 300 = 75 [½]

The BLAGAB *I–E* computation gives:

Year X+1 BLAGAB *I–E* = 1,300 – 1,000 = 300 [½]

We then compare this with the minimum profit as follows:

Year X+1 minimum profit = 350 [½]

The minimum profit is larger than the *I–E* computation. Therefore the allowable expenses in the *I–E* computation are restricted and the insurer becomes XSE. Expenses of 50 from the BLAGAB fund are carried forward to year X+2. [1]

In this case all the minimum profit is taxable at the corporation tax rate. So:

BLAGAB tax paid in year X+1 = 25% on 350 = 87.5 [½]

Adding together the non-BLAGAB and BLAGAB tax gives:

Year X+1 total tax = 75 + 87.5 = 162.5 [½]

[Maximum 7]

7.4 Lighter mortality means a higher life expectation …

… therefore a lower capital content …

… therefore a higher income content …

… therefore a higher *E* …

… thus reducing *I-E* …

… and thus reducing the tax payable by the life insurance company.

If the company is XSE, the lower tax bill will not be achieved immediately, but it may be possible to reduce future tax bills through the carry forward of the additional unrelieved *E*.

(The higher income content means higher policyholder tax.)

7.5 The current indexed gain (allowing for indexation to year end 2017 only, when this allowance became frozen) is:

£3,000 – £2,000 × 1.03^3 = £814.55

The net of tax rate of return assumed over the next year is 10% x 0.8 = 8%.

Therefore the deferred tax allowance is:

£814.55 × $v_{8\%}$ × 0.2 = £150.84.

7.6 (i) ***UK***

Higher tax would / may be payable on:

- BLAGAB business (taxed on *I-E*, which would normally be higher than profit) rather than non-BLAGAB business (taxed only on profit)
- within BLAGAB:
  - 'XSI products' that generate high investment returns and have low expenses, *eg* single premium savings products
  - life assurance savings products rather than general annuities, due to the income component deduction permitted for the latter
  - products that are backed by equity and property assets where gains are being actively realised
  - products that are backed by equities that have a low dividend yield (compared to those with a high dividend yield), due to the exclusion of dividends from taxable investment earnings
  - in an XSE company: products that are highly profitable, causing the minimum profit test to bite – perhaps permanently
- within non-BLAGAB:
  - policies / products that make high profits.

(ii) ***Ireland***

Higher tax would / may be payable on:

- 'old basis business' rather than 'new basis business' (as for UK BLAGAB *vs* non-BLAGAB)
- within 'old basis business': as for UK BLAGAB
- within 'new basis business': as for UK non-BLAGAB.

(iii) ***USA***

Higher tax would / may be payable on:

- policies / products that make high profits
- policies with high premiums (compared with policies with low premiums)
- products that are sold in high volumes
- policies written in States that have higher rates of premium tax
- within a State, policies written by an insurer based in another State rather than an insurer based in that State.

(iv) ***South Africa***

Higher tax would / may be payable on:

- individual life assurance savings and protection policies, which are allocated to the individual policyholder fund, *if* the average policyholder income tax rate is higher than the corporation tax rate (as is currently the case)
- corporate policies and more recent protection policies, which are allocated to the corporate fund, company policyholder fund and risk policy fund, *if* the corporation tax rate is higher than the average policyholder income tax rate.

(v) ***China***

Higher tax would / may be payable on:

- policies / products written in mainland China that make high profits
- policies / products written in Hong Kong with high premiums and/or that are sold in high volumes.

3 Treatment of groups

The 2007 financial crisis demonstrated that some financial institutions had become too big to be allowed to fail. As a result, banks in many countries were bailed out by their governments. Regulators were concerned that action should be taken to avoid this being necessary in the future.

Some insurance companies are of such size, market importance and global interconnectedness that their distress or failure would cause severe adverse consequences across the global financial system.

In this case, they may be subject to additional regulatory scrutiny.

For example in 2013, the International Association of Insurance Supervisors (IAIS) announced its intended approach to the identification of 'global systemically important insurers'. Shortly afterwards, the Financial Stability Board (FSB) published an initial list of nine such G-SIIs. This list is updated on an annual basis.

For example, the UK-based companies Aviva and Prudential are on the list.

G-SIIs are subject to enhanced supervision, including the need to have in place systemic risk management plans, enhanced liquidity plans and effective separation of non-traditional or non-insurance business (where feasible and appropriate).

So G-SIIs are subject to greater scrutiny by regulators and are required to hold more and higher loss absorbent capital and to prepare recovery and resolution plans. A similar system has been set up for global systemically important banks.

In 2020, the FSB decided to suspend identifying new G-SII companies, following the adoption of a new holistic framework: an activities-based approach for assessing systemic risk. This means making an assessment of the potential systemic risk arising from specific activities and exposures across insurance sectors, rather than focusing on specific institutions.

4 Statutory actuarial roles

In many jurisdictions there is a statutory requirement for a life insurance company transacting long-term business to appoint actuaries into certain positions. The titles applied to these roles vary depending on local regulations. For example, in the European Union under Solvency II there is a statutory requirement to have a Chief Actuary, whilst other jurisdictions have a requirement for an Actuarial Function Holder, Appropriate Actuary or Appointed Actuary.

The detail of any statutory actuarial roles and their responsibilities in a particular jurisdiction will be set out in the relevant regulatory rulebooks. These roles are also likely to be covered by any 'fit and proper persons' regulations. The holders are usually not allowed to fulfil other roles within a firm that would cause a conflict of interest, or if they do then the firm is required to declare these roles to the regulator.

The exact nature of the role may vary by jurisdiction, but examples of the types of responsibility allocated to a Chief / Appointed Actuary or Actuarial Function Holder could be:

- **ensuring the adequacy of technical provisions**
- **ensuring the appropriateness of the methodology and assumptions used to calculate the technical provisions**
- **assessing the sufficiency and adequacy of the data used to calculate the methodology and assumptions**
- **expressing an opinion on the adequacy of reinsurance arrangements.**

Responsibilities of the Appropriate Actuary include:

- **to carry out actuarial investigations in accordance with the rules and applicable professional guidance**
- **to report on those investigations**
- **to prepare an abstract of the report for publication and to provide the certificate or statement required.**

In some jurisdictions, a company that transacts with-profits business may have a statutory requirement to have a With-Profits Actuary in addition to either a Chief Actuary, Actuarial Function Holder or Appointed Actuary.

When a With-Profits Actuary is appointed, they usually cannot be a member of the Board of Directors. This may also apply to Actuarial Function Holders and Appointed Actuaries. However, subject to certain conditions, the Chief Actuary (or Actuarial Function Holder / Appointed Actuary) and With-Profits Actuary can sometimes be the same person.

Examples of the responsibilities of the With-Profits Actuary include:

- **to advise management on key aspects of the discretion exercised affecting with-profits business**
- **to produce a report to the firm's governing body at least once a year covering this advice, including those aspects of the firm's application of its Principles and Practices of Financial Management (PPFM) on which the advice was given**
- **to advise management on whether the assumptions used to calculate the future discretionary benefits within the technical provisions are consistent with the PPFM**
- **to produce a publicly available annual report for policyholders.**

  This report must confirm whether or not, in the opinion of the With-Profits Actuary, the firm has properly taken policyholders' interests into account in exercising its discretion and whether it has treated its customers fairly.

The With-Profits Actuary is a UK requirement, and may be called something different (or may be included within the head of the actuarial function role) under a different jurisdiction.

In respect of the roles of Chief Actuary (or Actuarial Function Holder / Appointed Actuary) and With-Profits Actuary a life insurer is often required:

- **to keep the actuary informed of the firm's business plans and to seek advice from the actuary of the implications of these plans for policyholders**
- **to pay due regard to the advice of the actuary**
- **to provide the actuary with adequate resources and provide such data and systems as may reasonably be required.**

Note that the details of the roles and responsibilities of statutory roles under Solvency II are examined in more detail in the next chapter.

It is planned that the FRC will be replaced with the Audit, Reporting and Governance Authority (ARGA) in 2023. This new regulatory body is expected to provide oversight of the UK actuarial profession.

The Code, all current APSs and non-mandatory guidance can be found under the 'Standards' section on the IFoA's website. The FRC's TASs can be found on the FRC's website [Framework for FRC technical actuarial standards].

2.2 The Actuaries' Code

The Code is the overarching ethical code of the IFoA. All members of the IFoA are expected to uphold the Code. The Code applies at all times to members' conduct in their work as actuaries and is also taken into consideration where members' conduct in other contexts could reasonably be considered to reflect on the actuarial profession.

As shown above, the Code sets out six core principles that all members of the IFoA are expected to observe to support the IFoA in acting in the public interest.

The content of the Code is outside the scope of this Subject, however all members (students and actuaries) of the IFoA are expected to be familiar with the Code and comply with its principles.

2.3 Actuarial Profession Standards (APSs)

Members are required to comply with all applicable provisions of APSs.

The following Actuarial Profession Standards were described in the Regulatory environment chapter:

- **APS L1: Duties and Responsibilities of Life Assurance Actuaries – relevant to all members appointed to one of the statutory roles.**

  The main statutory actuarial roles covered in the Regulatory environment chapter and the Solvency assessment (1) chapter are the Chief Actuary, the With-Profits Actuary and the Appropriate Actuary.

- **APS L2: The Financial Services and Markets Act 2000 (Communications by Actuaries) Regulations 2003 – guidance relating to the statutory obligation to 'whistleblow'.**

  Actuaries holding statutory roles may need to communicate certain matters to the regulators if they have concerns about an insurer. This is commonly referred to as whistleblowing.

  Matters that may need to be communicated to the regulators include:

  – contravention of legislation by an insurer
  – significant risk that an insurer's assets may become insufficient to meet liabilities
  – significant risk that the insurer did not or may not take into account policyholder interests.

Also of relevance to life insurance actuaries are:

- **APS X1: Applying Standards to Actuarial Work (effective 1 July 2017) – sets out principles to be applied by members to determine which standards they must or should be applying to a piece of work.**

  APS X1 is mainly relevant to members undertaking work which is outside the UK geographic scope of the TASs.

- **APS X2: Review of Actuarial Work – applies to all members and relates to the need to consider the extent to which review (including independent peer review) is required for any actuarial work, *ie* work undertaken by a member in their capacity as a person with actuarial skills on which the intended recipient of that work is entitled to rely.**

  APS X2 outlines a number of factors to consider when deciding whether a piece of actuarial work should be reviewed, *eg* the complexity of the work, its significance and the extent to which judgement is required. Reviewers should have appropriate experience and expertise and be able to perform the review objectively.

- **APS X3: The Actuary as an Expert in Legal Proceedings – applies to actuaries who are appointed to act as an expert witness in legal proceedings held before courts, tribunals or similar.**

  Members of the IFoA must not act as an expert witness if they do not have the necessary level of knowledge and skill or if their advice is not independent and objective. The fee paid to the expert witness should not be linked to the outcome of the proceedings.

2.4 Guidance Notes

Guidance Notes include specific mandatory requirements which members are expected to comply with, as well as non-mandatory material. Guidance Notes are beyond the scope of this course.

2.5 Non-mandatory resource material

The IFoA also provides non-mandatory guidance and resource material for members, their employers and other stakeholders.

This includes:

- **'Speaking up: a guide for members', which sets out the IFoA's view of good practice in relation to speaking up.**

  The IFoA has also produced a specific guide for employers of actuaries entitled 'Whistleblowing: a guide for employers of actuaries'.

  The IFoA has also put in place a confidential advice line that gives advice on when and how best to raise concerns. Details of the advice line and the above guides can be found in the Standards section of the IFoA website.

- **'Conflicts of interest: a guide for members' and 'Conflicts of interest: a guide for employers of actuaries'. These guides build on the provisions of the Actuaries' Code in relation to conflicts of interest and set out views on good practice regarding such conflicts and how they might be managed.**

  The guide for employers was withdrawn in 2020. Further material to assist in assessing and managing conflicts of interest can also be found in the Standards section of the IFoA website.

- **'A guide for ethical data science', which is intended to complement existing ethical and professional guidance and is aimed at addressing the ethical and professional challenges of working in a data science setting.**

(ii) ***Investments and the determination of unit prices***

Investments

Policyholders choose which fund or funds they wish to invest in, based on the descriptions provided in the product literature. For example, an investment mandate might specify whether a fund is to be actively or passively managed and give a target split between domestic and international investment, between fixed and real investment and whether the aim is for income or capital growth. [1½]

The fund managers are expected to comply with these descriptions, otherwise PRE / treating customers fairly would be breached. There should be a process in place whereby any non-adherence is identified and corrected. [1]

Non-unit liabilities have to be established to cover any expected excess of future expenses and death benefits over future charges. The investment of the assets backing these liabilities is at the discretion of the company. Usually, they are fixed-interest type assets. [1]

Unit pricing

The overriding principle here is known as the 'basic equity principle', which states that all unitholders not involved in a transaction should be unaffected by that transaction. [1]

This principle leads to two different methods (or bases) used to calculate unit prices:

- If a unit fund is *expanding*, then the net transaction is a purchase of units and so the price of each unit should be based on the offer market price of the underlying assets plus buying costs. This is known as an 'offer' basis. [1]
- If a unit fund is *contracting*, then the net transaction is a sale of units and so the price of each unit should be based on the bid market price of the underlying assets less selling costs. This is known as a 'bid' basis. [1]

Whichever basis is used, this price (after some adjustments) is the price at which policyholders may sell units. For funds with bid/offer spreads, this spread is added to give the price at which policyholders may purchase units. [1]

The choice of 'offer' or 'bid' basis is a matter of discretion and is usually not referred to in the product literature. In deciding when to move from an offer basis to a bid basis, or vice versa, the company should look at whether a fund is generally expanding or contracting. If this were to be looked at on a daily basis, there might be frequent changes in basis, which would produce more unit price volatility than policyholders would reasonably expect. [1½]

To help even out these fluctuations, companies often maintain a small 'manager's box', which is used to buy and sell excess units in the short term, rather than actually creating or cancelling units. This also helps to reduce dealing costs. [1]

A reasonable approach might be to look at the net transactions on a rolling quarterly-average basis and if this indicates a change in basis two months in a row, then change the basis. A more active approach than this is possible, but the important thing is to be consistent in the approach over time. [1]

PRE and the concept of treating customers fairly should also affect how the company deals with unit pricing errors. It has a duty to correct promptly all material errors and provide compensation where necessary. [1]

The company also needs to consider how it rounds unit prices, and may wish to ensure that it does not do so in a direction which consistently acts against the policyholder. [1]

Provisions should also be set up within the unit funds for the future expected gains tax liability on current unrealised gains on equities and property assets held within funds, since tax is not payable until such gains are realised. [1]

If no deduction is made from the unit price until tax is due to be paid, then there will be unitholders who suffer the tax without benefiting from the gain. There will also be unitholders who benefited from the gain but who left before the tax bill was paid. [1]

This is clearly out of line with PRE and so an appropriate adjustment for tax needs to be made on an ongoing basis. [½]

When the actual tax is payable, adjustments need to be made within the unit pricing calculation to reflect any difference between the provisions held and the actual tax due. [½]

In order to treat customers fairly, the objective should be to minimise these differences. [½]

[Maximum 11]

(iii) ***The circumstances under which charges might be altered***

The extent to which the charges may be altered will depend on:

- policy documentation
- the company's own past practice
- industry practice. [1½]

The situation is likely to be different for different types of charge and for different policies. [½]

Bid/offer spread

This is usually regarded as a fixed charge, specified in policy literature. [½]

Annual management charge (AMC)

Contracts written many years ago have a fixed AMC and so this charge cannot be varied for such policies. [½]

More recent contracts do have a variable AMC, but since this has never been varied, policyholders might reasonably expect this charge to remain at the same level in future. [1]

This will depend on what has been said in past policyholder communications. For example, if they have been reminded on a regular basis that this charge is variable and might be changed despite past practice, then it would be reasonable to vary the AMC in future. [1]

Increasing variable AMCs is likely to be in line with industry practice. [½]

As stated earlier, the company's overriding aim and policyholders' overriding expectation must be for the company to remain solvent, so it would be reasonable to increase variable AMCs to protect the solvency position, even if other considerations would suggest otherwise. [1]

Where the charge may be varied, the policy documentation will specify any restrictions. For example, there might be limits on the extent of each change and also an upper limit for the charge. The company might have to give policyholders advance warning of any change, in writing, to give them time to make any changes. [1½]

Initial nil allocation period

This is usually regarded as a fixed period. Policyholders are likely to be unhappy if this period is increased once the policy has started, especially if they were beyond this period and are now moved back within it. [½]

Expense deduction

Where this is fixed, there is obviously no scope to change it. [½]

However, there are other policies where this charge may be increased, with increases limited by either price or earnings inflation. Since these increases have been imposed from time to time, the company may reasonably continue this practice in the future without going against PRE. [½]

Since this charge is labelled an 'expense' deduction, care should be taken that any increases are the result of adverse expense experience and that increases are not used to make up for poor experience elsewhere. Also, the higher increases that are likely to be permitted with the earnings link should not be used to cross-subsidise policies where no increases are allowed. [1]

Since the increases have not been regular, policyholders might have differing views on when changes are likely to be made. The company could consider explaining its rationale if this is not already explained elsewhere, or it could change to a system of regular reviews. [1]

Allocation percentage

This is fixed at the outset of each policy, so there is no scope to vary this charge in respect of existing business. However, there is nothing to stop the percentages being changed for new business, as a result of a repricing exercise. If this is done, the company should consider the relative attractiveness of the old and new terms overall, to assess whether existing policyholders are likely to surrender their policies in order to take out a new one. [1½]

There is no surrender penalty mentioned for any contract, so the importance of persistency will depend on how quickly the initial expenses are recouped. [½]

[Maximum 9]

