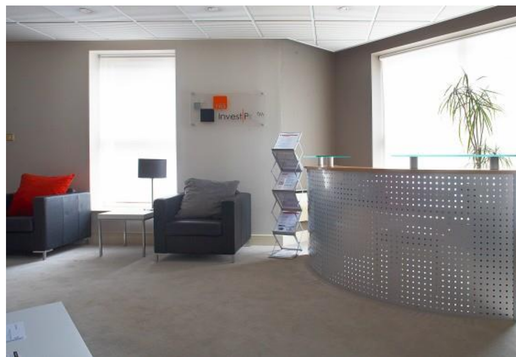
Knowledge based solutions



Research Update: May 2014

Tax Aspects of ABI Guide to Good Practice for Unit-Linked Funds

Unit-Linked Funds

George McCutcheon MSc FIA discusses the tax aspects of the "ABI Guide to Good Practice for Unit-Linked Funds"

Background

In our March research update on the revised consultation version of the "ABI Guide to Good Practice for Unit-Linked Funds", we promised a more detailed review of the tax aspects. In this research update, George McCutcheon discusses the tax issues in more detail.

Background

The amendments to the Guide were made by an ABI Working Group, in close liaison with the FCA, and reflect the changes that have been made in response to the FCA's TR13/08 "The governance of unit-linked funds".
With the formal adoption of the 2014 version of the guide, life companies are now required to review their existing policies and procedures. By 31 December 2014, firms should have reviewed their operations against the updated guidelines and begin making progress towards following them.

Key Conclusions –Implications for Life Companies

- It is apparent that life companies were interpreting the 2012 Guide in different ways. Some companies are applying the 7 year spreading rules for deemed disposals whilst others are not and for others the marketing material doesn't provide clarity on their approach. Both the lack of disclosure and the inconsistency in approach are of concern. Section 2.28 of the guide would seem to require that such disclosure is required (at the very least for the clear statement of standards required for the FCA).
- Life companies should carry out a detailed review of their tax provisioning methodology in the context of treating customers fairly. In particular, the interaction of tax provisioning and placing value on tax losses should be carefully reviewed in the context of Section 5.61 (preserving fairness between different generations of policyholders and between policyholders and shareholders)
- Most UK life companies place little or no value on tax losses in unit pricing. In this context, there is a **significant risk** that the non-application in unit pricing of seven year spreading of deemed disposals could result in unit pricing errors of significant magnitude –in particular for funds investing almost exclusively in external collectives and the level of error could be quite high in a year where there were large losses. This research update provides examples.
- In the same context, there is also a **significant risk** that the non-application in unit pricing of carry back rules for deemed disposals losses could result in unit pricing errors – in particular for funds investing almost exclusively in external collectives. This research update provides examples.
- If 7 year spreading and carry back provisions are not being applied in unit pricing, then tax losses c/f in a fund have two quite different components viz firstly the part that has arisen from the non-application of 7 year spreading and carry back provisions and secondly the residual part. For unit pricing purposes, the life company should place full value on the first part of the tax losses and then consider whether to place any value on the residual part. However there is a chicken and egg position as accurately quantifying the two parts requires the application of 7 year spreading and carry back provisions even if that is carried out off-line from the unit pricing systems and then manual adjustments would have to be made to the unit pricing to reflect an appropriate value on the tax losses.
- The assessment of whether the tax basis is fair has to be based on the overall tax charge taking account of the value placed on tax losses i.e. it is not solely about whether seven year spreading is applied.

Key Questions for Life Companies

- Do the life company's current methods of tax provisioning meet the requirements of the revised Guide?
- Does the life company's current approach to placing value on tax losses meet the requirements of the revised Guide?
- Is the life company satisfied that in the scenario of a year of large investment losses following a number of years of positive investment returns, that the company's current approach to tax provisioning would automatically result in appropriate and timely tax relief been given on those losses (such that no unit pricing error would be considered by the FCA to have occurred)

Copyright © 2014 Financial Risk Solutions Ltd. All rights reserved.

Key Findings of the FCA Thematic Review

The FCA's thematic review of the governance of unit-linked funds published in October 2013 identified some areas where life companies needed to make improvements to ensure that customers are treated fairly.

- Fair allocation of stock lending revenues and tax between customers and shareholders
- The identification and rectification of errors; and
- The management of potential conflicts of interest

Tax Best Practice

Tax Best Practice Checklist

- Not Excel based ✓
- Separate allowance for various components of taxable return ✓
- Mirrors life company tax regime ✓
- Seven year spreading, matching rules, carry back of losses ✓
- Daily tax calculations (integrated with fund valuations) ✓
- Robust systems in place ✓

FRS InvestPro

Potential Problems if Systems are not Robust

- If not applying 7 year spreading for deemed disposals : What if large losses arise?
- If not applying carry back: What if large losses arise?
- If tax calculations are not integrated into fund valuations: Are tax provisions consistent with asset values?
- Value placed on tax losses: What happens if fund moves from expanding to contracting?
- If issues are identified in arrears: Pricing errors with problems of resolution and compensation?

FRS InvestPro

Tax

The FCA thematic review found that improvements were required in just under half of the firms in the sample. These typically related to the consistency of approach across different types of funds and the fair treatment of losses.

Tax - Funds of Funds

Copyright © 2014 Financial Risk Solutions Ltd. All rights reserved.

The FCA found that whilst customers were being told that funds were taxed on a standalone basis that funds established as 'funds of funds' had their tax based on the combined total of the tax for the individual sub-funds. The FCA said that there was no perfect solution in this area but firms should ensure their approach to the apportionment of tax is reasonable and delivers a broadly fair result for customers.
The 2014 Guide seeks to address this through changes in disclosure requirements [1] and also with new provisions in Section 5.64 viz "In addition, firms should:

- Ensure that the offsetting of losses against gains before calculating tax liabilities is done fairly and consistently.
- Document their processes and procedures for offsetting gains and losses and have in place systems and controls to ensure those processes and procedures are correctly applied.
- Aim for consistency of approach in offsetting gains and losses and the rationale for any inconsistency should be documented with a view to ensuring that all policyholders are being treated fairly."

Tax - Fairness
There is a FCA requirement that customer benefits are calculated fairly and accurately (and that there is fair allocation of tax between customers and shareholders).
The 2014 Guide has a new provision "5.61 .....However, the pricing methodology adopted should seek to preserve fairness between different generations of policyholders and between policyholders and shareholders" and an amended provision "5.63 The following factors should be considered ...

- Appropriate relief for external expenses charged to the fund.
- The discounting of tax rates where there is likely to be a prolonged period from the pricing date until the expected date of payment of the tax, for example on deemed and unrealised gains or losses. The approach to discounting should also be consistent with the settlement of tax provisions, or the holding of cash within a fund against the provision, required to avoid accidental or inappropriate gearing of the fund".

FRS Comment on Tax Changes
The section on tax in the 2012 Guide comprised about half a page. That has been extended to about two pages.
The key change is section 5.61 prescribing that the pricing methodology should seek to preserve fairness between different generations of policyholders and between policyholders and shareholders (whereas the 2012 Guide 4.5.9 only required broad equity between generations of policyholders and fairness between the company and the fund and qualified both by "if appropriate". Section 5.62 sets out that tax calculations should be in accordance with the overarching principle of Treating Customers Fairly.
There are two potential key consequences:

- Fairness between different generations of policyholders (as distinct from broad equity as per 4.5.9 of the 2012 guide) may require renewed focus on an appropriate methodology for placing value on tax losses in unit pricing[2]
- Fairness between policyholders and shareholders may require a review of the method of quantifying the amount of tax losses and in particular that seven year spreading of deemed disposals and two year carry back of deemed disposal losses should be applied in unit pricing for that purpose

The two related issues of carry back and seven year spreading are reviewed separately below.

Tax – Carry Back Rules for Deemed Disposals
Section 5.63 includes "The firm should ensure that the value of the fund takes account of any appropriate tax relief attributable to asset classes held in the fund."
One such asset class is those assets to which deemed disposals apply. A form of tax relief applicable to this asset class is the carry back provisions under S212 TCGA 1992 i.e. if at year end there is a deemed disposal loss, this can be carried back and set off against the deemed disposals gains of the last 2 accounting periods starting with the most recent accounting period.

[1] 5.60 ... For funds where tax charging basis varies from the firm's standard approach, e.g. where the standalone basis is not applied, such variations should be disclosed, if material to the policyholder outcome."

[2] The full detail of such a methodology is outside the scope of this research update. If you have queries on that, please contact FRS.

Copyright © 2014 Financial Risk Solutions Ltd. All rights reserved.

Example		Year 1	Year 2	Year 3	Total
Deemed Disposals		900	100	-1,200	-200

Tax Charge by Year	Year 1	Year 2	Year 3	Total	Loss c/f
7 Year Spreading with carry back	180	20	-200	0	200
7 Year Spreading without carry back	180	20	-146	54	471
No Spreading	180	20	0	200	1,200

Table 1.1

- The proper application of the carry back tax provisions would mean that 1,000 of the deemed disposal losses would be offset against previous deemed disposal gains. The tax charges in unit pricing on the 900 and 100 would be reversed and there would be 200 tax losses c/f.
- If a life company were not applying the carry back rules in unit pricing then it is possible that tax relief might be given only on the spread forward deemed disposals of 729 (being 5/7*900+6/7*100) i.e. tax charges of 200 less tax credit of 146 and tax losses c/f of 471. Thus tax would be over-provided by 54k in unit pricing (reflecting the fact that there were 271 extra unrelieved tax losses c/f)
- If both carry back and seven year spreading were not being applied, then it is possible that no tax relief might be given meaning that tax would be over-provided by 200k in unit pricing (reflecting the fact that there were 1,000 extra unrelieved tax losses c/f).

In practice with seven year spreading, the maximum that the tax deductions could be overstated if carry back was not applied would be 0.2 * 2/7 * deemed disposal loss in year 3. This maximum arises where deemed losses in year 3 equal year 1 deemed gains and there are no deemed gains in year 2. If such deemed disposals losses were say 20% of start year 3 gross assets (not extraordinary for funds investing almost exclusively in external collectives), the non-application of spreading could result the fund unit price being understated by 1.4%.

Tax – 7 Year Spreading of Deemed Disposals

In the March research update, FRS highlighted the risk, if a life company is not applying seven year spreading of deemed disposals and is also placing little or no value on tax losses, that likely scenarios could arise where the standard unit pricing approach resulted in unfair unit prices for customers and that the life company might not detect that in good time to prevent unit pricing errors arising. We said that this was a potentially very significant issue in certain scenarios and promised a detailed research update on the issue. This research updates explores this issue in more detail below.

The new provision 5.61 requiring fairness between policyholders and shareholders is significant and particularly in the context of 5.63 which provides that factors to consider when choosing the basis of levying charges in respect of taxation include consistency with the tax regime of life companies. Fairness between policyholders and shareholders can be assessed based on the standalone fund tax approach[3].

As previously stated, Section 5.63 requires that the value of the fund should take account of any appropriate tax relief attributable to asset classes held in the fund. Seven year spreading on deemed disposals gains is one form of tax relief applicable to collective investment schemes.

The non-application of seven year spreading of deemed disposals in a scenario where a year of large tax losses (whether realised or deemed disposals) follows a number of years with positive deemed disposals could cause unfairness between policyholders and shareholders unless the value placed on tax losses in unit pricing appropriately adjusted for that feature. The risk is that, whilst the correct application of spreading would result in all or most of the tax losses being tax relieved on the corporate tax regime basis, a unit pricing tax approach that didn't apply spreading and didn't place much value on tax losses wouldn't give policyholders appropriate tax relief on those losses. That would be an unfair outcome particularly as part of the rationale (implicitly accepted by the Inland Revenue) for spreading is to avoid the situation where an uneven pattern of gains and losses over a number of years resulted in an unfairly high amount

[3] Defined as where the tax charged on the unit fund is exactly the tax charge that the life company would pay under the corporate tax regime if the life company consisted solely of the unit fund (and there were no shareholder profits).

Copyright © 2014 Financial Risk Solutions Ltd. All rights reserved.

of tax being paid by the life company and by extension by policyholders.

The ABI Guidelines are generally not prescriptive and are instead principles based and that is generally accepted as appropriate. However it is arguable that it would have been clearer if the 2014 Guide had stated that it is best practice to apply seven year spreading of deemed disposals where such spreading would have a material effect on the tax provisions in a unit fund.

This issue is particularly important for funds investing almost exclusively in external collectives as deemed disposals would represent a significant proportion of total taxable returns. This is a potentially very significant issue. It would not be unusual in a very bad year for investment markets to have a 30% fall in asset values (impacting both realised gains and current year deemed disposals). Consider an example where the investment return figures for each of the three previous years were positive and were 50% of the current year negative investment return. Suppose that the life company was placing little or no value on tax losses in unit pricing.

The key question is what proportion of the 30% fall in asset values would be covered by the spreading forward of deemed disposal gains.
This depends on a number of factors:

- Percentage of assets subject to deemed disposals
- Percentage of investment return that arises as realised gain

Suppose the fund's gross assets at start of the current year were 10,000 with a tax provision of 900 and hence net asset value of 9,100.

Gross Assets at Start of Year 4		10,000				
Investment Return					-30%	
		Year 1	Year 2	Year 3	Year 4	Total
Investment Return		1,500	1,500	1,500	-3,000	1,500

Consider the example below of a fund that holds only external collective funds which are subject to the CGT deemed disposals rule.

100% of Assets subject to Deemed Disposals						
Realised Proportion of investment return		0%	10%	20%	40%	60%
Proportion of Tax Losses covered						
No Spreading		0.0%	0.0%	0.0%	0.0%	0.0%
7 Year Spreading with no carry back		100.0%	96.4%	85.7%	64.3%	42.9%
7 Year Spreading with carry back		100.0%	100.0%	100.0%	77.1%	51.4%
Tax Charge for Year 4						
No Spreading		0	0	0	0	0
7 Year Spreading with no carry back		-600	-579	-514	-386	-257
7 Year Spreading with carry back		-600	-600	-600	-463	-309
% Effect on Unit Price (compared to No Spreading)						
7 Year Spreading with no carry back		**9.8%**	**9.5%**	**8.4%**	**6.3%**	**4.2%**
7 Year Spreading with carry back		**9.8%**	**9.8%**	**9.8%**	**7.6%**	**5.1%**
Tax Losses c/f as % of Gross Assets						
No Spreading		42.9%	42.9%	42.9%	42.9%	42.9%
7 Year Spreading with no carry back		0.0%	1.5%	6.1%	15.3%	24.5%

Copyright © 2014 Financial Risk Solutions Ltd. All rights reserved.

7 Year Spreading with carry back		0.0%	0.0%	0.0%	9.8%	20.8%

Table 1.2

Explanatory Notes:

- The figure of 6.3% (for the 40% realised proportion data point for seven year spreading with no carry back) means that the unit price would be 6.3% higher than the unit price (with no seven year spreading and no carry back) where no value is placed on the different level of tax losses c/f for the two approaches.
- With the 30% fall in asset values, the fund's gross assets become 7,000 and the tax provision is 900 less the year 4 tax charge
- For the 40% realised proportion data point, 64.3% (see calculation note)[4] of the tax losses are covered by 7 years spreading and 1,071 of tax losses are carried forward. This means that the year 4 tax charge is -0.2*(3,000-1,071) i.e. -386. If seven year spreading was not applied combined with zero value placed on the tax losses, the year 4 tax charge would be zero. The resultant fund value would be 6,100 compared to the spreading result of 6,486 i.e. the unit price would be 6.3% higher if seven year spreading was applied.
- The percentage difference in unit prices reflect the differences in the tax losses c/f e.g. for the 40% realised proportion data point, 20% of the difference between 42.9% and 15.3% is 5.5% of gross assets which is 6.3% of net assets.
- Logically the % effect reduces as the realised proportion increases (as that diminishes the importance of the seven year spreading).
- The example could be refined to include a run-off period (to realisation) on the unrealised gains but that extra complexity isn't required to illustrate the effect.

The overall effect would be even greater if carry back was applied in conjunction with the seven year spreading.

FRS Comment on Table 1.2 results

- The scenario is not extreme. The non-application of seven year spreading combined with little or no value being placed on tax losses would result in significant unfairness as the % effect on the unit price is way too high.
- For the 40% realised proportion scenario, the quantified effect is 6.3%. In fact the position could be worse than the 6.3%. This is because tax losses without spreading would be 43% of gross assets and with spreading would be 15% of gross assets. For a contracting fund the life company might place some value on the 15% tax losses but would place no value on 43% tax losses.
- If we assumed that the fund size was 2 times higher so that the fall in asset values was only 15%, the result at the 40% realised proportion with no value placed on tax losses is still a price effect of 2.4%. Tax losses without spreading would be 18% of gross assets and with spreading would be 6% of gross assets.
- If we assumed that the fund size was 4 times higher so that the fall in asset values was only 7.5%, the result at the 40% realised proportion with no value placed on tax losses is still a price effect of 1.1%. Tax losses without spreading would be 8% of gross assets and with spreading would be 3% of gross assets.
- The percentage effect depends on the approach taken to placing value on tax losses.

The conclusion is that the non-application of seven year spreading if combined with the carry forward of tax losses with little or no value placed thereon could result in significant understatement in the unit price compare to the life office tax regime basis (for funds where 100% of assets are subject to deemed disposals).

However it would be argued that most funds aren't 100% invested in external collective funds subject to deemed disposals.

Consider the case where the fund is only 30% invested in external collective funds.

30% of Assets subject to Deemed Disposals						
Realised Proportion		0%	10%	20%	40%	60%
Proportion of Tax Losses covered						
No Spreading		100.0%	94.5%	84.0%	63.0%	42.0%
7 Year Spreading with no carry back		100.0%	100.0%	100.0%	82.3%	54.9%
7 Year Spreading with carry back		100.0%	100.0%	100.0%	86.1%	43.4%
Tax Charge for Year 4						

[4] The spread forward deemed disposals are 0.6 * {4/7*1,500+5/7*1,500+6/7*1,500} =1,929 being 386 for year 4 and 1,543 for subsequent years. The realised gains in year 4 are 0.4*-3,000 + 386 +0.6 * -3,000/7 =-1,071. Hence tax losses c/f =0.6*6/7*3,000 +1,071 -1,543=1,071. Hence (3,000-1,071)/3,000 =64.3% of the tax losses are covered by 7 years spreading

Copyright © 2014 Financial Risk Solutions Ltd. All rights reserved.

No Spreading		-600	-567	-504	-378	-252
7 Year Spreading with no carry back		-600	-600	-600	-494	-329
7 Year Spreading with carry back		-600	-600	-600	-517	-345
% Effect on Unit Price			0	0	0	0
7 Year Spreading with no carry back		**0.0%**	**0.5%**	**1.5%**	**1.8%**	**1.2%**
7 Year Spreading with carry back		**0.0%**	**0.5%**	**1.5%**	**2.1%**	**1.5%**
Tax Losses c/f as % of Gross Assets						
No Spreading		0.0%	2.4%	6.9%	15.9%	24.9%
7 Year Spreading with no carry back		0.0%	0.0%	0.0%	7.6%	19.3%
7 Year Spreading with carry back		0.0%	0.0%	0.0%	5.9%	24.2%

Table 1.3

There are two different effects here. For the deemed disposal assets, logically the % effect reduces as the realised proportion increases (as that diminishes the importance of the seven year spreading). For the other assets, the % effect reduces as the realised proportion reduces (as that means that there are more unrealised gains against which the negative investment return can be offset).

In the above table, consider the case where the realised proportion is 40% where 82.3% (see calculation note)[5] of the tax losses are covered by 7 years spreading and thus 531 of tax losses are carried forward. This means that the year 4 tax charge is -494.

FRS Comment on Table 1.3 results

- The scenario is not extreme. The % effect on the unit price is still too high.
- For the 40% realised proportion scenario, the effect is 1.8%. Tax losses without spreading would be 16% of gross assets and with spreading would be 8% of gross assets.
- If we assumed that the fund size was 2 times higher so that the fall in asset values was only 15%, the result at the 40% realised proportion with no value placed on tax losses is still a price effect of 0.7%. Tax losses without spreading would be 7% of gross assets and with spreading would be 3% of gross assets.
- If we assumed that the fund size was 4 times higher so that the fall in asset values was only 7.5%, the result at the 40% realised proportion with no value placed on tax losses is still a price effect of 0.3%. Tax losses without spreading would be 3% of gross assets and with spreading would be 1% of gross assets.
- The percentage effect depends on the approach taken to placing value on tax losses. If full value was being placed on tax losses, then there would be no price effect. Full value might be placed for the 2 times higher and 4 times higher scenarios as the size of tax losses is quite small.
- For the 40% realised proportion scenario, for a fund with only 10% of assets subject to deemed disposals the effect is still a material 0.6%.

The conclusion is that the non-application of seven year spreading if combined with the carry forward of tax losses with little or no value placed thereon could result in material understatement in the unit price compare to the life office tax regime basis (even for funds where only 30% of assets are subject to deemed disposals).

A lot depends on the approach taken by the life company to placing value on tax losses. If full value is being placed on tax losses, then non-application of seven year spreading might not disadvantage customers. However there is a specific scenario risk because the circumstances in which the non-application of seven year spreading might cause problems are also the circumstances in which the basis for placing value on tax losses might be changed with unintended problematic consequences. Thus if seven year spreading was not being applied and full value was being placed on tax losses but then large losses arose and then no value was placed on tax losses, the non-application of seven year spreading in unit pricing combined with the change in tax loss value basis could result in unit pricing errors.

[5] The spread forward deemed disposals are 0.3*1,929 =579 being 116 for year 4 and 463 for subsequent years. The realised gains in year 4 are 0.4*-3,000 + 0.3*386 +0.3*0.6 * -3,000/7 =-1,161. The cumulative unrealised gains are 0.7*0.6*1,500=630. Hence tax losses c/f =0.3*0.6*6/7*3,000 +1,161 -463-630=531. Hence (3,000-531)/3,000 =82.3% of the tax losses are covered by 7 years spreading

Copyright © 2014 Financial Risk Solutions Ltd. All rights reserved.

To seek to resolve that operational risk through the value placed on tax losses presents the unit pricing team with a very difficult task. The problem for the life company in that scenario is that it can't ensure a fair outcome for policyholders without carrying out some detailed analysis to sub-divide the tax losses into two parts viz firstly the part that has arisen from the non-application of 7 year spreading and carry back provisions and secondly the residual part.
The computational problems are apparent. The life company knows the total of tax losses but how does it split that into the two parts?
The most efficient solution is that seven year spreading and carry back provisions are applied directly within the unit pricing valuations.

Copyright © 2014 Financial Risk Solutions Ltd. All rights reserved.

Biography; George McCutcheon MSc FIA:

Mr. McCutcheon is a graduate of University College Dublin in Mathematical Science and is a Fellow of the Institute of Actuaries. He is a director and co-founder of Financial Risk Solutions (FRS), a software company specialising in the licensing of fund administration software to life assurance companies.

He has presented a number of papers at the Life Convention of the Institute of Actuaries and has co-authored a number of papers for the Society of Actuaries in Ireland, including a 2011 paper on placing value on tax losses in unit linked funds.

About Financial Risk Solutions (FRS)

Financial Risk Solutions Ltd (FRS) is a leading provider of unit pricing and fund accounting software to the Life Assurance and Pensions industries. It was founded in 1999 by actuaries and IT specialists and is one of the leading software providers in its sector. Its Invest|Pro™ product family is a recognised leading benchmark in the investment fund accounting area and customers are some of the biggest brands in Life Assurance and Third Party Administration including MetLife, SEB, IFDS Percana, and Accenture Managed Services.

FRS's mainline product Invest|Pro™ manages unit pricing and portfolio valuations, asset/liability unit matching, box management, trade order management, investment accounting, financial reporting and compliance with investment mandates in a single application. Product types covered include unit linked funds, portfolio bonds, self-invested/directed pensions, shareholder funds and with-profit funds. Invest Pro™ was specifically designed to securely automate complex fund administration processes.

For more information contact george.mccutcheon@frsltd.com or visit www.frsltd.com

Copyright © 2014 Financial Risk Solutions Ltd. All rights reserved.