

# IFS Newsalert

## Solvency II - The Tax Issues

### PwC Ireland Financial Services Tax Group

PwC is a leading provider of tax services to business in Ireland's IFS sector. This group provides advice and news on Irish and international tax issues - and tax-related business issues - affecting IFS businesses in Ireland. Specialisms within the group include banking, treasury, asset finance, securitisation, **insurance**, and investment management.

### PwC Ireland Insurance Tax Group

PwC Ireland's insurance tax group is a leading provider of tax services to both domestic and international insurance groups.

For issues relating to this Newsalert please contact your usual PwC tax contact or the tax specialists listed at the end of this document.



This edition of the IFS Newsalert focuses on the potential tax implications and opportunities arising from **Solvency II** as well as the potential tax implications arising from the subsequent implementation of **IFRS 4 Phase II**.

Solvency II is a fundamental, once in a generation, regulatory change which will have an impact on nearly every insurance company in the EEA. It is scheduled for implementation by January 2013 and is designed to create a risk and capital framework for supervision of insurance and reinsurance operations across the EEA, to maximise the harmonisation of requirements across the EEA and to further promote the single market in insurance services. IFRS 4 Phase II will set down the principles for determining liabilities under insurance classified contracts for accounting purposes.

The tax implications of Solvency II (and IFRS 4 Phase II) are considered as follows:

- Impact on non-life insurance tax computations
- Impact on life insurance tax computations – new basis business
- Impact on life insurance tax computations – old basis business
- Territorial scope of Solvency II
- Legal entity structures – subsidiary v head office/branch structures
- R&D tax credit for expenditure on model development

This news bulletin is intended to provide a general guide to the subject matter. Professional advice should be taken before acting on any information contained in this document.



## Impact on non-life insurance tax computations

The regulatory and accounting treatment of insurance contracts is currently undergoing significant change due to the impending implementation of Solvency II and IFRS 4 (Insurance Contracts) Phase II. The main issues arising from the implementation of Solvency II (and subsequent implementation of IFRS 4 Phase II) relate to:

- the elimination of claims equalisation reserves; and
- the adjustment to the methodology for the calculation of technical provisions.

### Claims Equalisation Reserves

In general, claims equalisation reserves (CER) are not deductible for tax purposes and therefore their elimination will have a neutral tax effect.

However, transfers into CER in respect of credit business transacted by non-life (re)insurers are deductible for Irish tax purposes while transfers out of the reserve are taxable. Under Solvency II, CER will be released immediately and the question arises as to how this release should be treated for tax purposes in the absence of new measures to provide for a tax deductible CER. There are similarities to the question that arose a number of years ago regarding the taxation of one-off profits/losses on the introduction of IFRS. It would appear logical to apply a similar approach to that applied on

the introduction of IFRS i.e. one-off adjustments (whether positive or negative) were spread over a five year period. This would be a reasonable approach particularly given that CER will have built up gradually over a period of time. A legislative change would be required to implement this approach.

A number of other jurisdictions currently allow a deduction for CER and we are aware that at least one such territory has considered the issue and intend to amend their tax system so that a tax deduction for a CER equivalent will be available post Solvency II, notwithstanding that a reserve will not be required for regulatory purposes. Other countries are also considering the issue but is not clear yet whether they intend to retain CER for tax purposes. From a competitive viewpoint it will be important that CERs continue for tax purposes in Ireland in order to retain and grow credit business here.

In summary, issues for industry consideration are as follows:

- Should some form of equalisation reserve be maintained for tax purposes going forward?
- If not, how should the release of the reserve be treated for tax purposes? Should a transitional adjustment be allowed for the release of a claims equalisation reserve on implementation of Solvency II?

### Technical Provisions

The Irish Revenue currently accept that technical provisions for accounting purposes (Irish GAAP and IFRS) are an appropriate measure of tax deductible reserves. This is on the basis that accounting technical provisions are required for regulatory purposes and are generally in line with the ABI SORP on Accounting for Insurance Business.

With regard to the tax treatment of technical provisions going forward, consideration needs to be given to the impact of the following events:

- the implementation of Solvency II which is expected to be effective 1 January 2013; and
- the implementation of IFRS 4 phase II with effect from 1 January 2014 or a later date.

### Solvency II and Technical Provisions

Solvency II proposes changes in the methodology for the calculation of technical provisions which will be mandatory for regulatory purposes.

Although the accounting position remains somewhat uncertain at this stage, it is possible that the new Solvency II methodology could also impact the calculation of technical provisions for accounting purposes (i.e. if the ABI SORP on Accounting for Insurance business is amended to align with Solvency II). The impact on the accounting position is also likely to vary between organisations depending on the basis on which technical provisions are currently prepared for accounting purposes.

Where the Solvency II methodology for the calculation of technical provisions is adopted for accounting purposes, this will have important consequences for the computation of taxable profits and would likely give rise to a one-off adjustment which may be either positive or negative. Overall the expectation is that Solvency II reserves will in general be lower, and if this is the case, the result would be a one-off increase in profits which in turn would create a significant tax exposure. As set out above in relation to claims equalisation reserves it would seem reasonable to apply a similar approach to that applied



on the adoption of IFRS which would mean that the one-off adjustment would be spread over a number of years for tax purposes. A legislative change would be required in order to implement this approach.

#### *IFRS 4 Phase II and Technical Provisions*

IFRS 4 (Insurance Contracts) Phase II will set down the principles for determining liabilities under insurance classified contracts. Phase II is expected to be implemented on 1 January 2014 at the earliest (at which date IFRS is expected to have replaced Irish GAAP for all entities above a certain size) and is likely to give rise to a one-off adjustment which may be either positive or negative. Again, this change will have important consequences for the computation of taxable profits as it is likely to give rise to a one-off adjustment on the transition.

In summary, issues for industry consideration are as follows:

- Post 1 January 2013 (expected implementation date), will Solvency II impact the methodology for calculating technical provisions for accounting purposes?
- Are transitional measures required for tax purposes to spread the impact of the implementation of Solvency II and/or IFRS 4 Phase II?

### **Impact on life insurance tax computations – new basis business**

Similar issues arise here in the case of technical provisions as for non-life business. The tax computation for new basis business is based on the transfer to the non-technical account and this should continue to be the case. The question of a profit surge on the recasting of technical provisions may be less significant here, as the long-term business provisions are already subject to discounting. In the event that any change is significant, the spreading option would again seem to be an appropriate mechanism for mitigating the impact of this change.

### **Impact on life insurance tax computations – old basis business**

The principal issue here arises in connection with the calculation of the notional Case 1 (NC1). At present this is based on the regulatory surplus. It is unlikely that an appropriate shareholder profit figure will be available from the Solvency II regulatory return and therefore consideration needs to be given to an appropriate alternative basis that could be used as the starting point of the NCI. There are a number of alternatives including the following:

- continue with the current methodology (but without a return to support the mechanism) which would require companies to maintain a separate set of actuarial figures for

tax purposes only. This is likely to be impracticable and would impose an excessive administrative burden on companies, particularly given that old basis business is in run-off;

- use a figure extracted from the Solvency II regulatory return with appropriate adjustments. This could prove difficult because of uncertainties connected with the new return and because the new return is mainly focused on capital adequacy as opposed to profits. It is also the case that the return will be subject to post implementation review, which might result in significant changes. There would seem to be too much uncertainty associated with this methodology, particularly for a business in run-off; or
- use a figure based on the financial statements. This is a profit measure and is already in place for new basis business. Therefore, this appears to be the logical option.

#### **Transition from regulatory return to accounts basis**

If it is decided to move the NCI computation from a regulatory return basis to an accounts basis, the transition would give rise to a number of one-off adjustments as follows:

- **Technical provisions**  
Technical provisions currently used in the calculation of regulatory surplus would change to an accounts basis. The tax treatment of any differences will need to be considered.

- Deferred acquisition costs (DAC)**  
 In the case of direct life writers, acquisition costs are expensed immediately in the calculation of the regulatory surplus but can be deferred on an accounts basis. It would be necessary to disallow the cumulative DAC asset at the date of change when it is expensed to the Income Statement in order to prevent a double deduction for these expenses.
- Undistributed Surplus**  
 The tax treatment of undistributed surplus as at the date of change would also need to be considered. It appears that there should not be a one-off tax adjustment in respect of this item given that the total profits of the life business (policyholder and shareholder profit) will already have been taxed in the I-E computation and therefore nothing will have fallen out of the charge to tax. The NCI computation is not a taxable trading profit computation in its own right - it merely measures the shareholder share of profit to be used in the I-E computation.

## Territorial scope of Solvency II

A significant question facing (re)insurers is how Solvency II will apply to worldwide operations where, for example, both EEA and non-EEA operations are held by a single EEA holding company. If non-EEA operations are in scope under the proposed provisions, restructuring could take them out of scope and reduce Solvency II related capital and operational requirements. Some groups are currently reorganising group structures in order to ensure that non-EEA operations are not impacted by Solvency II. The tax implications of any such reorganisations need to be carefully considered.

A number of non-EU territories including Bermuda and Switzerland are seeking Third Country Equivalence which would bring the regulatory reporting regimes in those territories in line with Solvency II. It remains to be seen if these territories achieve equivalence by 2013.



## Legal entity structures – subsidiary v head office/branch structures

Many insurance and reinsurance groups have legal and operating structures which have evolved over a long period of time with the result that there can be substantial inefficiencies. Many of these groups are seeing the advantages of moving to a more centralised structure. More efficient use of capital is the big driver for making this change - as full benefit cannot be taken for excess capital held in subsidiaries, groups are considering whether the capital position could be improved by moving to a head office/branch structure. Regulatory and operating efficiencies can also be achieved by, for example, getting rid of multiple underwriting platforms.

There are also opportunities on the direct tax side. Effective tax rates can be driven down by locating key functions in a low tax central location. There are also tax challenges - invariably when you move to a more centralised structure paradoxically this can result in more services moving cross-border and it is important to ensure that this does not create new VAT costs.

Many groups are using the impending approach of Solvency II as an opportunity to review their group structures with a view to realising the capital, regulatory, operating and tax efficiencies outlined above.

## Research & development (R&D) tax credits for expenditure on model development

It is worth bearing in mind that expenditure on the development of the new regulatory capital model and related system changes may be eligible for R&D tax credits thereby potentially reducing costs in relation to IT expenditure. Consideration should be given to the qualifying criteria for R&D tax credits when documenting system development and/or changes.

## Conclusion

While Solvency II represents a very significant change to the regulatory regime for insurers it also gives rise to significant tax issues as outlined above. Solvency II will not be implemented until 1 January 2013 but it is important that the related tax issues are considered well in advance of the implementation date. The resolution of the tax issues will be important to ensure that there is certainty regarding the tax assumptions being used in the regulatory capital model. Some of the issues will require engagement with the Revenue Commissioners/Department of Finance as legislative amendments and/or the issue of a Revenue Statement of Practice will be required and it is likely that this process will take some time. It is important that industry engages early in a consultation process with the Revenue Commissioners/Department of Finance in order to ensure that the tax issues are resolved in good time.

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## Your contacts for Solvency II tax and other issues

PricewaterhouseCoopers is at the forefront of the current Solvency II debates and has a multi-disciplined, multi-jurisdictional team of professionals who are available to assist you with every aspect of your preparations for Solvency II.

To discuss the tax and other implications of Solvency II in more detail, please speak to your usual PricewaterhouseCoopers contact or one of the people listed:

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