

Appendix 34B

Tax matters relating to the reattribution of the inherited estates of CULAC and CGNU Life

A report for the policyholder advocate in connection
with the reattribution of the inherited estates
of CGNU Life and CULAC with-profits funds

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1.00 Introduction

1.01 Background

We were appointed by the policyholder advocate and the FSA to:

- (1) Review and report on Aviva's tax analysis of the impact of the reattribution exercise;
- (2) Advise on the UK direct tax implications of the reattribution;
- (3) Review the tax provisions in the:
 - draft Aviva Scheme dated 6th April 2009 ("the Scheme");
 - Report to the Directors by the Actuarial Function holder ("AFH report") dated 7th April 2009; and
 - Report to the Directors by the With Profits Actuary dated 7th April 2009 ("WP report").
- (4) In relation to tax matters, assist the policyholder advocate in her negotiations with Aviva.

The taxation of UK life assurance business is complex so, as an introduction, we have provided a summary of the current regime in section 3 of this Appendix. Subsequent sections of the Appendix consider the following aspects which are relevant to the reattribution.

- The historic position in relation to shareholder tax and the impact thereon of the reattribution - section 4. This is relevant in the assessment of the amount of inherited estate available for reattribution.
- The tax treatment of policy benefits received by policyholders, including the PIP due to be paid to eligible electing policyholders and the treatment of benefits received by eligible non electing policyholders - section 5.
- Tax aspects relevant to the ongoing management of the life funds following reattribution - section 6.

- Scheme provisions and comments on the WP report and the AFH report – section 7.

During the course of our work we have reviewed the Aviva tax department’s tax paper (Appendix 34 N) and met with the group tax department of Aviva plc to obtain explanations of their tax analysis of the reattribution. A summary of this Appendix is set out in section 8.

This Appendix is based on our understanding of UK tax legislation, as enacted, at 7th July 2009.

2.00 Summary

2.01 The taxation of UK life insurance business

The UK tax rules that apply to life assurance companies are complex. The objective is to tax the company on both the profits it earns from writing insurance contracts, commonly referred to as *shareholder tax*, and returns that will eventually be paid to policyholders, commonly referred to as *policyholder tax*.

Broadly, shareholder tax is charged at the normal corporation tax rate, currently 28%, on a life company’s surplus “profit” for the period covered by the FSA return. In calculating taxable surplus, any policyholder tax liability is allowable as a deduction from the taxable surplus.

Life assurance companies write different types of insurance policies. Some are tax favoured, as the investment return that accrues in the life company funds prior to being paid out to policyholders as benefits is not subject to taxation. A pension policy is an example of a tax-favoured policy. For other policies, this investment return is subject to corporation tax, currently at the rate of 20%, as it accrues in the life company. This is referred to as the policyholder tax and is paid by the life company as a proxy for the policyholder. Section 3 of this Appendix provides more detail on the UK life tax regime.

When policyholders receive benefits from a UK life company in respect of their policies, they may be subject to taxation. Usually, for an individual policyholder who is a UK tax resident, he or she will be subject to income tax at their marginal tax rate on the benefits received that relate to investment return. For those policies not tax favoured, credit is given at 20%. To the

extent policy benefits relate to insurance claims, for example, the sum (in excess of the investment gains) payable as a death benefit, there is usually no income tax liability for the policyholder. In addition, certain types of policy are exempt from any income tax liability on investment gains. These are referred to as qualifying policies and are usually endowment-type policies meeting certain pre conditions.

In section 2.03 and 2.04 we comment on the impact on the inherited estate reattribution of shareholder tax, as the amount of this tax is a cost in determining the size of estate available for reattribution. We then summarise in section 2.05 the tax treatment of the PIP received by eligible electing policyholders, compared to the taxation of policy benefits, if any, arising from the estate received by eligible non electing policyholders.

2.02 Shareholder tax

The regulatory value of the inherited estate is based on the excess of life company assets over liabilities, measured on a 'realistic' basis. This excess is calculated after allowing for the policy benefits expected to be paid to policyholders and any associated shareholder profits the life company is entitled to in respect of with-profit policies. These profits will usually be subject to shareholder tax.

In accordance with FSA guidance and historic practice, Aviva has charged the shareholder tax to the inherited estate. Charging shareholder tax to the estate is one of the practices which the policyholder advocate does not believe should be permitted by the FSA. Since shareholder tax is not permitted to be charged to asset shares, it means that estate capital is treated differently from the rest of the fund. This is against the legal advice she has been given which is covered in Appendix 25, and the arguments against the practice are covered in Appendix 39 'The impact of FSA guidance on policyholders'.

As a simplified example, say the life company has total assets of 1,100 and liabilities for future policy benefits payable to policyholders of 900, then the life company entitlement (assuming a 90:10 share) would be 100, giving total liabilities of 1,000. The shareholder tax liability at 28% on the 100 life company profit is 28. Rather than deducting this shareholder

tax liability from the 100 profit it is deducted from the total life company assets of 1,100. As a result the inherited estate is 72 (1,100 assets less 1,028 liabilities).

In the above example, if shareholder tax was not charged to the inherited estate, then the shareholder entitlement would reduce by 28 (100 profit less shareholder tax of 28) and the inherited estate would increase by 28 to 100, being assets of 1,100 less total liabilities of 1,000, comprising policyholder benefits due of 900, net of tax profit due to shareholders of 72 and shareholder tax of 28.

One of the principles agreed by the policyholder advocate with Aviva and with the FSA is that non-electing policyholders should be in no worse a position than if there had not been a reattribution. This means that if the FSA changes its rules on shareholder tax, and prevents the tax being charged to the estate in future, this benefit should be enjoyed by the OWPSF and not overridden by provisions in the Scheme. Under the terms of the Scheme, Aviva is permitted but not in terms required to amend the Scheme to give effect to such a rule change and the policyholder advocate considers this to be a clear detriment to non-electing policyholders compared to the position if there had been no reattribution. The policyholder advocate has asked Aviva and the FSA to put the protection in place, but as yet, her view is that the Scheme does not provide this protection.

2.03 Shareholder tax following reattribution

Following reattribution, that part of the inherited estate which the policyholders have agreed to transfer will belong to the shareholders rather than being available for distribution to policyholders. In accordance with the Scheme, the inherited estate will be allocated to the AVLAP NPSP. If, subsequently, Aviva removes the inherited estate from the long term insurance funds of AVLAP its value at the time of exit will be treated as profit subject to shareholder tax. After a reattribution the Company owns the reattributed estate, and so any shareholder tax paid out of the estate is in effect paid by shareholders. Since this tax is currently borne 90% by policyholders this is a cost that shareholders are taking on. As a result it is a cost that has to be taken into account in the value of a reattribution to shareholders, and as such has been deducted from the value of the estate before any division is

made of the residual value of the estate between shareholders and policyholders. This deduction is only necessary because of the FSA concession that permits shareholder tax to be deducted from an estate but does not permit this tax to be deducted from asset shares.

At year end 2008 the shareholder tax calculated by Aviva to be deducted from the inherited estate was £278m. This figure is based on 100% take up of the offer by the policyholders. It is also based on the current corporation tax rate of 28%. However, the mix of business reduces the effective rate and, based on the 2006 mix, the estimated effective shareholder tax rate calculated by Aviva is 17.5%. We have been advised by Aviva that the effective shareholder tax rate at 31st December 2008 was 19.6%. As noted in section 3.03 of this Appendix, the Finance Bill 2009 may reduce future effective rates.

Under the current tax rules the actual shareholder tax is affected by the normal rates of tax in force and the mix of business at the time the reattributed inherited estate is available to be transferred by Aviva from the AVLAP long term fund. In addition, we also make the following observations regarding the calculation of shareholder tax.

- If the inherited estate following reattribution is regarded as sufficiently fungible such that Aviva can utilise the capital attributed to shareholders without the need to transfer it from the AVLAP long term business fund, no shareholder tax liability should arise under the current UK tax regime.
- There may be certain management actions, driven by commercial or non-tax circumstances, which could reduce the shareholder tax rate of 17.5% estimated by Aviva. Conversely, there may be other situations where, for commercial reasons, management actions result in a net benefit to the shareholders, notwithstanding an increase in the shareholder tax rate.

While the FSA permits shareholder tax to be charged to the estate new business assumptions affect the value of shareholder tax. This is because the shareholder tax on profits from new business written after reattribution is also assumed to be charged to the inherited estate. Therefore, if new business volumes vary the profit and hence the value of the shareholder tax cost to the estate will change.

These factors and the complexity of the life tax rules mean that there is a range of possible outcomes for the actual rate of shareholder tax. During negotiations with Aviva we confirmed to the policyholder advocate that, in our view, we consider the adoption of a lower shareholder tax rate of 15% as reasonable.

2.04 Charging shareholder tax to the inherited estate

We have noted above that, in accordance with current FSA guidance and historic practice, Aviva has assumed an amount of shareholder tax to be deducted from the inherited estate for the purpose of negotiating the proposed payments to eligible policyholders.

On 19th June 2008, the House of Commons Treasury Committee called upon the FSA to consult by the end of 2008 on the practice of charging shareholder tax to inherited estates, with a view to disallowing the right to make a charge. On 6th October 2008, the FSA responded to the Treasury Committee and in Appendix 1 of the Treasury Committee's Fifteenth Special report, the FSA commented that they would not change their view about shareholder tax but would, in accordance with usual FSA practice, keep this rule, along with the general framework, under review. If FSA guidance and practice subsequently changed, the value of inherited estates will increase as the value of the shareholder tax liabilities should no longer be deducted from the inherited estate. For purposes of comparison only we note that if the shareholder tax liability was not permitted to be charged to the inherited estates, then, based on the Aviva calculations, estimated shareholder tax of £101m on profits from in force policies (section 2.02 refers), would increase the value of the inherited estate. In addition, usually, when assets are removed from the with-profit funds and not allocated to policyholder benefits a tax charge arises at that time. However as the reattributed estate is being transferred to the NPSF no tax liability arises at that time. Instead it will arise as and when the assets are released and a surplus is recognised in that sub fund. The estimate of this shareholder tax liability is £278m and this has been factored into the calculations because under the FSA concession shareholder tax is borne by the estate.

New business assumptions affect the valuation of shareholder tax the estate is expected to bear in future. This is because the shareholder tax on profits from new business written after

retribution on the reattributed estate will be borne 100% by shareholders rather than 90% by policyholders through the estate, and this loss of value to shareholders from this FSA concession has to be taken into account in the calculations. Thus, if new business volumes vary, the profit and hence the relevant deduction for shareholder tax should change.

2.05 Taxation of Policyholders

As noted in section 2.01, the receipt of policy benefits can be subject to income tax. The rules are complex and the extent of any liability will depend on the policyholder's specific tax position and the type of policy concerned.

Broadly, the tax treatment varies depending on whether the receipt by the policyholder is in respect of a life or pension policy.

Life policies are classified as either qualifying or non-qualifying. Usually, any benefits paid to policyholders in respect of qualifying policies, such as endowment type contracts meeting certain pre conditions, are not subject to income tax. However, benefits relating to investment gains on non-qualifying policies are usually subject to income tax at the policyholder's highest marginal rate but with certain reliefs, for example an allowance is made to reflect the policyholder tax paid by the life company. Pension policy benefits received by a policyholder are usually subject to income tax, calculated at the individual's highest marginal rate.

The special distributions announced in February 2008 should be treated in the hands of the policyholder as a normal policy benefit. In general, a life policy is subject to tax when a claim or payment is made. This means that special distributions will be taxed at the time the claim or payment is made not the time when the special distribution is added to the policy benefits. A basic rate UK resident taxpayer generally pays no tax, whereas a higher rate UK resident taxpayer usually pays tax at 20%, unless the policy is qualifying, in which case there will be no tax due. If the Finance Bill is enacted in its current form, from 6th April 2010 onwards some higher rate tax payers could pay 30% or, in some cases, 40% tax. For pension policies

the policyholder will usually be taxed on receipt of payment at their marginal rate of income tax.

Electing eligible policyholders will receive a PIP. In respect of life policyholders, Aviva has confirmed with HMRC that the receipt of the cash PIP should not be subject to income tax. We have reviewed this agreement and concur with the conclusion.

With regard to electing eligible pension policyholders, based on our understanding of the Scheme terms, we concur with Aviva's view that the PIP should meet the requirements of Statutory Instrument 2007/3532, The Registered Pension Schemes (Authorised Member Payments) Regulations 2007, such that it should not, in most circumstances, be treated as an unauthorised payment. If the amount was treated as an unauthorised payment there would be tax deductible at rates between 40% and 55%. If the Finance Bill 2009 is enacted in its current form the 40% tax rate will increase to 50% for some higher rate tax payers.

In addition, we concur with Aviva's view that a cash PIP should not be deductible for the purpose of calculating the tax liability of AVLAP. This contrasts with the position of the special distribution which should be deductible in calculating the AVLAP tax liability.

Our understanding of the Scheme is that eligible non electing policyholders will not receive a PIP. To the extent they subsequently receive policy benefits arising from participation in OWPSF assets, the payments will be subject to the normal tax rules applying to policy benefits.

2.06 Ongoing management of the life funds – tax features

Following reattribution of the inherited estate, Aviva will hold the assets in the AVLAP NPSF. Under the current tax rules, until the assets are available to be transferred from the AVLAP long term fund, the life tax rules will apply and subject any investment return arising from the assets to a corporation tax charge. This is referred to as the tax frictional cost and, based on the 2006 mix of business, is estimated to be at a tax rate of 6.9%. We have reviewed this calculation and consider it to be reasonable. Based on the current mix of business, the frictional rate is 10%. This 3.1% increase reflects the change in Aviva's asset backing away

from equities and towards bonds. 10% seems consistent with current market trends but in the longer term this rate will depend on the nature of the assets backing the business (i.e. a move back towards equities may impact on the frictional tax rate). For the purpose of assessing Aviva's proposals the rate of 6.9% has been used as the figures were based on 2006 assumptions.

In calculating the value to the shareholders of the offer to the policyholders, Aviva and the policyholder advocate allowed for this frictional cost. This is on the basis that if the attributed assets were removed from the AVLAP long term fund this frictional cost would cease. In principle, the policyholder advocate considers it likely that Aviva will, over time, remove some or all of the reattributed inherited estate from the AVLAP long term fund.

During negotiations with Aviva, the policyholder advocate considered the arguments for a tax liability arising on attributed estate investment returns in the event attributed assets are removed from the AVLAP long term fund. Based on high level calculations we estimate that the corporation tax liability on such investment returns could be in the region of 23%, assuming the same mix of assets is held in a UK corporate entity. This 23% rate of tax replaces the lower frictional tax rate of 6.9%, in effect suggesting there is a 'reduced tax rate' benefit for Aviva by maintaining reattributed inherited estate assets in the AVLAP long term fund.

Also relevant to the tax frictional cost, Aviva, under the Scheme, cannot start to remove the reattributed inherited estate from the AVLAP long term fund until 2015. The policyholder advocate's view is that the Aviva offer should be based on FSA guidance which permits the company to extract the reattributed inherited estate from the AVLAP long term fund after 3 years. The policyholder advocate considers it is Aviva's choice to hold the reattributed inherited estate in the AVLAP long term fund for longer, and this does indicate that the Company is happy to keep its capital in the AVLAP long term fund for longer than it is required to, and hence that there may in practice be a 'reduced tax rate' effect.

We understand that these divergent tax rate and timing assumptions have been taken into account by the policyholder advocate in her recommendation to policyholders. We

understand that after extensive discussions between Aviva and the policyholder advocate about the ‘reduced tax rate’ benefit for assets held in the NPSF, it was not possible for the policyholder advocate to put a value on the reduced tax rate benefit because it was not possible to justify a value for this effect empirically. This does not mean that there is not a ‘reduced tax rate’ effect just that it was not possible to justify the effect robustly enough in practice to merit including a valuation for it in the calculations.

Aviva has modelled the effect on the ongoing tax profile of AVLAP following a reattribution. The modelling was undertaken by KPMG Tax. In addition to providing tax advice to Aviva, KPMG has provided actuarial advice to the policyholder advocate. It was agreed by the policyholder advocate and Aviva that KPMG could advise both parties in this way on the basis of internal procedures under which there would be no contact of any type on Aviva matters between the actuarial team advising the policyholder advocate and the tax team advising Aviva.

We did not have access to the whole of the tax model output or underlying data during our review, because Aviva considered that, as KPMG Tax had prepared the model, provision of the information would not be cost effective. Instead, Aviva has provided us with a summary report prepared by KPMG Tax and discussed it with us. During these discussions, we received explanations of the report content and were provided with extracts of the model output. Based on this scope of review we have not identified any features of the KPMG Tax model summary report which are unusual or inconsistent with either explanations received or other material we have reviewed for the purpose of our engagement.

The tax effect of the Scheme is calculated in the model by Aviva to be a net increase in total company level corporation tax of £41m, on a present value basis, over a 25 year model horizon. Aviva does not intend to allocate any of this increased tax cost to the with-profit sub-funds. This total tax cost comprises £24m in relation to the reattribution and £17m in respect of the merger of CULAC, CGNU Life and AVLAP.

We note that included in the £17m merger tax cost are tax synergies of £21m, when the standalone tax charges of the with-profit funds are compared to the total AVLAP entity tax

charge. Aviva has confirmed it intends to effectively credit all of this benefit to shareholders rather than disaggregate the £17m tax cost between a shareholder tax cost of £38m and a with-profit fund (policyholder) benefit of £21m.

The Scheme includes provisions to allocate the corporation tax arising post reattribution between the various parts of the AVLAP long term fund on the assumption that the NWPSF is taxed as if it were a standalone proprietary life company. Any tax costs or synergies, representing the difference between the Scheme methodology and the actual long term fund tax charge of AVLAP accrue to the NPSF. However, it should be noted that in accordance with the Scheme if this results in a material difference to the stand alone calculation then the Board has to consider the fairness of the allocation.

2.07 Review of Aviva tax department's tax paper

Section 8 refers to appendix 43 N – Aviva's commentary on the tax issues. We have reviewed this paper and have no additional comments. As noted above, there are different views that can be taken as to the tax rate to be applied to the removal of the inherited estate from the with profits funds and who should incur shareholder tax. We have commented on these aspects in Section 4 of this appendix.

3.00 The taxation of UK Life insurance business

3.01 Overview

The taxation of UK life insurance business is summarised in section 2.01.

The trading profits earned by the life company from life assurance business are taxed at the UK corporation tax rate (currently 28%), based on the measure of profits in the FSA regulatory return. In addition, the life company pays corporation tax on some of the investment return which accrues for the benefit of policyholders.

The way in which the UK life tax regime works is that investment return accruing in the long term insurance fund for the benefit of policyholders with policies that are tax favoured is not taxed as it accrues. Broadly speaking, the investment return is taxed in the policyholder's hands when the policy benefits are paid out. This type of business is referred to as Gross

Roll-up Business (GRB) and is mainly Pension Business, Overseas Life Assurance Business, and a few other small categories of business. By contrast, the investment return on “life” policies is taxed on the life company, as proxy for the policyholder, as it accrues in the long term insurance fund. This category of business is known as Basic Life Assurance and General Annuity Business (BLAGAB).

The tax charge for a UK life assurer combines the ‘proxy’ tax charge on BLAGAB policyholder investment return (at the ‘policyholder rate’, currently 20%), with the charge on the trading profits of the life company from all categories of business (at the standard ‘shareholder rate’, currently 28%). To fund the tax it pays to HMRC as proxy for BLAGAB policyholders, the insurer will normally reduce its liability to the policyholder in respect of policy benefits. The charge (or credit in the case of tax relief on negative investment return) to the policyholder is normally an approximation of the actual tax charge borne by the company, based on the judgment of the life company having regard to the principles of the tax regime, the ‘treating customers fairly’ regulatory principle and insurance policy terms and conditions.

3.02 Mechanics of the tax calculation

For a company writing both GRB and BLAGAB in ‘normal’ trading conditions, the profits chargeable to tax at the policyholder and shareholder rates respectively are calculated as follows:

- (1) Calculate the investment return on BLAGAB, net of expenses of managing that business;
- (2) Combine step 1 with the net trading profit derived from GRB (taxed as Income and Corporation Taxes Act 1988 Schedule D Case VI income – referred to below simply as Case VI), to give the total “Income less Expenses” (I-E) result; and
- (3) Compare the I-E result (step 2) with a notional calculation of the total profit as if the company had been taxed as a ‘normal’ trading company. If the I-E result

is less than the trading profit of the company then an amount called the excess adjusted Case I profit 'EACIP', is added to the I-E result and taxed. The slice of the I-E result corresponding to the trading profit is taxed at the shareholder corporation tax rate, with the balance taxed at the policyholder corporation tax rate.

There is a complication in that the tax on profits charged at the policyholder rate is itself deductible in the Notional profit calculation. It can be demonstrated mathematically that this results in an incremental rate of tax on each additional £1 of Notional profit, assuming no change to the overall I-E result, of 10%, rather than 8% (28%-20%). Conversely, adjustments to the I-E result which do not impact the trading result will normally have an iterated impact of 18%.

To reflect this iteration, the calculation of the shareholder tax rate can be expressed as $(28\% - 20\%) / 0.8 = 10\%$, where 28% and 20% are the standard corporation tax and policyholder tax rates respectively, 8% is the difference between these rates and 0.8 is the gross-up factor, being 1 minus the policyholder tax rate of 20%.

As noted above, if the initial calculation of the I-E result is less than the trading profit, EACIP is imputed to make the I-E result equal to the trading result. An amount equal to this EACIP income will be carried forward as BLAGAB management expenses, available for relief in future periods. Therefore, the impact of an EACIP adjustment is to create a current period tax liability and partially offset it with a deferred tax asset which can be used against future BLAGAB income and gains in subsequent periods.

As there are different tax calculations for BLAGAB and GRB categories of business, it is necessary to allocate the long term insurance fund investment return between them. Firstly, investment return from linked assets is allocated to the category of business the linked assets are supporting. The remainder of the long term insurance fund (non-linked) investment return needs to be apportioned between BLAGAB and GRB. There are complex rules on how to do this in the Income and Corporation Taxes Act 1988.

For BLAGAB, the life tax regime allocates any long term insurance fund realised gains and income on the basis of average policyholder liabilities of the entire long term insurance fund, modified to take account of income and gains which are specifically linked to the categories of business.

Investment return is allocated to GRB on a sub-fund by sub-fund basis, with different rules depending on whether or not the sub-fund contains with-profit business. The with-profit sub-funds have sufficient investment return allocated to them to fund both the policyholder bonus and the amount of surplus allocated to shareholders. For non-profit sub-funds, the investment return is allocated on the basis of average policyholder liabilities of the particular sub-fund.

It should be noted that because of the different allocation rules for BLAGAB and GRB, it is quite possible for more or less than 100% of the long term insurance fund investment return to be allocated across the categories and taxed.

Permanent Health Insurance business (PHI) is another category of insurance that can be written in a long term insurance fund. However, unlike life assurance business, it is taxed on a general insurance company basis by reference to the Generally Accepted Accounting Principles (GAAP) profits. The investment return is taxed as it arises and it is irrelevant whether it forms part of the surplus.

3.03 Recent legislative developments

The consideration of the reattribution commenced in 2006. Since then there have been a number of material changes to the UK tax regime. In the PBR 2007, the Chancellor of the Exchequer announced the following proposed changes which could impact directly or indirectly on the tax position of life companies.

- Change in the capital gains tax rate for individuals to a flat 18%.
- Removal of the inherited estates anti-avoidance legislation.
- Changes to the tax treatment of reassurance of life insurance.

Aspects of the proposals were developed in consultation with the life insurance industry prior to inclusion in the Finance Act 2008. On the basis of the current legislation the effects could be as follows:

- The flat rate 18% on capital gains is lower than the “proxy” rate which life companies pay on capital gains. This and the fact that higher rate taxpayers are charged an additional 20% (or higher if Finance Bill 2009 is enacted in its current form) on many life products may make these products less attractive than other saving products. However, it should be noted there are other non tax factors that are relevant when considering the attractiveness of life policies.
- The removal of the inherited estates anti-avoidance legislation removes a tax risk from Aviva. However, there remains uncertainty as HMRC have indicated there may be adjustments to the apportionment rules referred to in 3.02 above.
- The reassurance changes are targeted at perceived abuse by life companies. The PBR proposals were refined following industry consultation with the intention of addressing the specific abuse identified by HMRC. If the changes result in higher tax being suffered by AVLAP, we understand that this will be borne by the shareholders.

On 24th November 2008 the Government announced the PBR 2008. Although there were no life tax specific issues, it was announced that a consultation document would be produced which would include proposals to exempt foreign portfolio dividends from tax in the hands of large and medium sized companies. If this legislation applies to life companies such as AVLAP then the effective rate should be reduced, as foreign dividend income, which is currently taxable at 28%, would be taxable at nil. The impact will depend on the proportion of foreign dividends, which we understand from Aviva is such that the impact on the tax rate is not likely to be significant.

The Finance Bill 2009 contains draft legislation with a view to enact, as from 1 July 2009, the changes to foreign dividends noted above. In addition it contains the following provisions which may be of relevance to life companies and their policyholders:

- There will, from 6th April 2010, be a higher rate charge at 50% on those with income over £150,000.
- From the same date personal allowances are to be withdrawn from those with income over of £100,000 on a £1 for £2 basis – this gives a marginal rate of tax of 60% for income between £100,000 to £112,950.
- From 6th April 2011, tax relief on pensions will be reduced for those with income over £150,000 so when taxable income reaches £180,000 the relief will only be at 20%. There are anti forestalling provisions as from 22nd April 2009.
- As from 22nd April 2009 life companies which pay special distributions and PIP payments from the Long term Business Fund will not be allowed a tax deduction unless the amounts are funded by amounts which have been brought into account for tax.

The above measures may have the impact of reducing the amount of pension business sold to high net worth individuals and also occupational pension policies.

4.00 Shareholder tax

4.01 Charging shareholder tax to the inherited estate

Consistent with FSA guidance, it has been the practice of Aviva to charge the inherited estates of CULAC and CGNU Life with shareholder tax. In this context, shareholder tax is the tax which arises at the full UK corporation tax rate (currently 28%) on the allocation of surplus to shareholders. As has been commented on above, the policyholder advocate does not think that it is appropriate for the FSA to permit shareholder tax to be charged to the estate when it is not permitted to be charged to asset shares.

Building on the summary of UK life taxation in section 3 of this Appendix, the incidence of shareholder tax will depend on the type of insurance company.

A mutual insurance company has no shareholders. Rather, it is owned by its policyholders. Therefore, it is accepted for a mutual company that all tax is ultimately borne by the with-profits policyholder funds as there is no shareholder interest. Whilst, in theory, there should be no shareholder tax (as the total tax liability of the company should equal the policyholder

tax charge on BLAGAB business) an excess of actual tax over the theoretical policyholder tax amount can occur, for example if there are costs disallowed for tax purposes, giving rise to an amount of GRB Case VI profit. The resulting profit is taxed at the lower policyholder tax rate to reflect the fact that there are no shareholders. In the case of BLAGAB, the I-E result will also be taxed at the policyholder rate. The total of the GRB and BLAGAB tax at the policyholder rates is charged to the long term insurance fund. However, the policyholder asset shares will have been charged an amount which is an approximation of their tax liability (tax on the BLAGAB I-E result) and this can be credited against the total tax charged to the long term insurance fund.

In a proprietary (shareholder owned) company the position is similar, but with two key differences to reflect the shareholder interest.

- (1) The trading profit from the long term insurance fund is subject to a shareholder tax liability at the normal corporation tax rate.
- (2) Policyholder tax is deductible for the purpose of calculating shareholder tax. Due to the iterative nature of the policyholder tax deduction (see section 3.02 of this Appendix), the effective tax rate on BLAGAB (assuming the standard rate of corporation tax is 28%) shareholder and policyholder attributes is 10% and 18% respectively. Generally, the shareholder tax rate on GRB business remains at 28%.

CULAC, CGNU Life and AVLAP are proprietary life companies. It should be noted that for BLAGAB it is not the policyholders who pay the policyholder tax; rather it is the company which pays, as “proxy” for the policyholder, as part of its corporation tax liability. As a consequence of the policyholder tax liability being borne at the corporate rather than individual level, policyholders effectively benefit from a tax deduction for expenses of managing the business as the benefit is usually implicit in how the policy premium has been calculated. Conversely, all realised capital gains accruing for the benefit of policyholders are taxed whereas if such gains arose directly in the hands of the policyholder they would benefit from any unutilised personal capital gains tax annual exemption.

4.02 Shareholder tax prior to reattribution

The “Realistic Balance Sheet” (RBS) working capital amount at year end 2008 of £1,440m is the starting point of the calculation by Aviva of its offer to policyholders to buy out their share in the inherited estate. This amount of £1,440m is net of a deduction for shareholder tax of £98m. The reason for this deduction is that when Aviva’s share of profit, equivalent to 1/9th of policyholder bonuses, is distributed from the long term insurance fund in the form of surplus, there will be an incremental shareholder tax charge. In accordance with historic practice and current FSA guidance this shareholder tax is borne by the inherited estate.

4.03 Shareholder tax following reattribution of the inherited estate

In calculating its offer to policyholders, Aviva has assumed that post reattribution it will at some future point in time remove the reattributed assets from the AVLAP NPSF. Based on the current UK life tax rules this will result in a shareholder tax liability in respect of the value of the reattributed assets at the point in time of removal. Consistent with historic practice and FSA guidance of charging shareholder tax to the inherited estate, the policyholder advocate has reduced the value of the inherited estate available for reattribution for this estimated future shareholder tax liability. This is because this is a benefit shareholders would have received if there had been no reattribution, but after a reattribution shareholders will have to pay this tax themselves. If there were no such deduction shareholders would be worse off as a result of the reattribution, and would have been less likely to make a reattribution offer to current policyholders. The policyholder advocate therefore had to make allowance for this FSA concession to shareholders.

Under the current tax rules, the actual shareholder tax rate is affected by the normal rates of tax in force and the mix of business at the time the reattributed inherited estate is made available for transfer by Aviva from the AVLAP long term fund. The current rate of corporation tax in force is 28%.

At year end 2008, the shareholder tax calculated by Aviva to be deducted from the inherited estate is £278m. This is based on an effective shareholder tax rate of 19.6%; which differs

from the standard rate of 28% due to the mix of business at year end 2008. Based on the 2006 mix of business, the estimated effective shareholder tax rate calculated by Aviva was 17.5%.

In addition, we also make the following observations regarding the calculation of shareholder tax.

- If the inherited estate following reattribution is regarded as sufficiently fungible such that Aviva can utilise the capital attributed to shareholders without the need to transfer it from the Aviva long term business fund, no shareholder tax liability should arise under the current UK tax regime.
- There may be certain management actions, driven by commercial or non-tax circumstances, which could reduce the shareholder tax rate of 17.5% estimated by Aviva. Two examples of management actions are the transfer of pension annuities from AVLAP to another company and the making of strategic, rather than passive, investments by the reattributed inherited estate.
- Conversely, there may be other situations where, for commercial reasons, management actions result in a net benefit to the shareholders, notwithstanding an increase in the shareholder tax rate.

These factors and the complexity of the life tax rules mean that there is a range of possible outcomes for the actual rate and hence the amount of shareholder tax. During negotiations with Aviva we confirmed to the policyholder advocate that, in our view, we consider the adoption of a lower shareholder tax rate of 15% as reasonable.

New business assumptions affect the valuation of shareholder tax the estate is expected to bear in future. This is because the shareholder tax on profits from new business written after reattribution will be borne 100% by shareholders rather than 90% by policyholders through the estate, and this loss of value to shareholders from this FSA concession has to be taken into account in the calculations. Thus, if new business volumes vary, the profit and hence the relevant deduction for shareholder tax should change.

In relation to shareholder tax following reattribution, we have the following comments.

- Following the reattribution transaction, the inherited estate will be located in the AVLAP NPSF. Aviva should obtain a one-off tax benefit from the transaction due to the higher level of PHI business written in the AVLAP NPSF compared to that of CULAC and CGNU Life. Under current UK tax legislation, if and when the inherited estate is extracted from the AVLAP long term insurance fund, the tax rate is estimated to be 17.5%.
- The effective tax rate of 17.5% is an estimate based on the current profile of business as at end of 2006. This calculation can obviously change over a period of time and therefore affect the calculation of the shareholder tax liability. As noted above, the rate estimated by Aviva had moved to 19.6% by end of 2008. However, Aviva plc tax department has stated that over the period of the KPMG Tax model the effective tax rate is in the region of 20%, although this is based on the previous UK corporation tax rate of 30%. We have been provided with an extract of the model which demonstrates this observation.
- Aviva's calculations assume there will be no explicit management action which results in a reduction in the shareholder tax liability. For example:
 - The transfer of annuities in payment business (internally or externally) can reduce the amount of shareholder tax; and
 - AVLAP could acquire a structural asset with the reattributed funds rather than hold portfolio assets. Compared to a 'base case' scenario of portfolio assets held by the AVLAP NPSF, provided any reduction in value for FSA return purposes is not accounted for in the FSA return form 40 Revenue account, the value of dividends from a structural asset investment are allocated, for tax purposes, to the shareholders without suffering any extra tax charge, therefore reducing the shareholder tax rate when compared to investment in portfolio assets. There may be regulatory factors to consider in this scenario. We are informed by Aviva that they have no plans to acquire a structural asset.

HMRC is undertaking a review of the apportionment of investment return rules referred to in section 3.02 of this Appendix, which could result in the shareholder tax rate of 17.5% calculated for the purpose of the reattribution increasing or decreasing with effect from 2010.

4.04 Charging shareholder tax to the inherited estate

On 19th June 2008, the House of Commons Treasury Committee called upon the FSA to consult by the end of 2008 on the practice of charging shareholder tax to inherited estates, with a view to disallowing the right to make a charge. On 6th October 2008, the FSA responded to the Treasury Committee and in Appendix 1 of the Treasury Committee's Fifteenth Special report, the FSA commented that they would not change their view about shareholder tax but would, in accordance with usual FSA practice, keep this rule, along with the general framework, under review. If FSA guidance and practice subsequently changed, the value of inherited estates will increase as the value of the shareholder tax liabilities should no longer be deducted from the inherited estate. For purposes of comparison only we note that if the shareholder tax liability was not permitted to be charged to the inherited estates, then, based on the Aviva calculations, estimated shareholder tax of £101m on profits from in force policies (section 2.02 refers), would increase the value of the inherited estate. In addition, usually, when assets are removed from the with-profit funds and not allocated to policyholder benefits a tax charge arises at that time. However as the reattributed estate is being transferred to the NPSF no tax liability arises at that time. Instead it will arise as and when the assets are released and a surplus is recognised in that sub fund. The estimate of this shareholder tax liability is £278m and this has been factored into the calculations because under the FSA concession shareholder tax is borne by the estate.

5.00 Taxation of policyholders

5.01 Tax rules applying to insurance policies

The taxation of UK insurance policies is complex. What is set out below is only a simplified explanation of the rules. The rules are different for corporate and overseas policyholders. Readers of this Appendix cannot rely on this explanation and should seek their own tax advice.

For life policies, when policy benefits are received as a result of the death of a policyholder or on the maturity, surrender, part surrender or on certain assignments of the policy, these events may be treated as chargeable events.

Certain life insurance policies may have no tax liability on payout unless surrendered within the first ten years. These are referred to as qualifying policies and are usually regular premium policies with a minimum duration. For all other policies, the calculation of the gain is complex. On a death, the amount treated as proceeds is the surrender value immediately before death. This means that death policies which have no investment content are effectively exempt from tax. In the case of investment policies, the premiums are deducted from the proceeds (less any excluded death benefit). If there have been previous partial surrenders or other chargeable events, these will be taken into account. If the event is a partial surrender, whether the policy is taxable at that time will depend upon a number of factors including premiums paid, whether there have been previous partial surrenders of the policy and the number of years the policy has been in force since the last partial surrender. In general up to 5% of the original premium can be taken in a tax-deferred manner for a maximum of 20 years.

Having calculated the chargeable event gain, it is then necessary to determine how much income tax is payable in respect of the gain. Provided the insurance company is subject to the UK life insurance tax rules, there is no basic rate income tax liability on policy benefit chargeable event gains. This reflects the fact that the investment return will be included in the insurance company's tax calculation as outlined in section 3.01 of this Appendix.

To calculate whether the gain is subject to higher rate tax, a portion of the gain, "top slicing relief", is added to all other taxable income of the policyholder and the effective rate of this top slice is applied to the whole of the gain. Top slicing relief reflects the fact that the chargeable event gain may have arisen over a number of tax years. However, for individuals in receipt of higher personal allowances, the full gain (not the top sliced amount) is taken into account when calculating the entitlement to the higher personal allowance.

The taxation of pension policy benefits is different compared to life insurance policies. Broadly, all amounts received by the policyholder are subject to income tax at the policyholder's highest marginal tax rate.

5.02 Taxation of the PIP in hands of policyholders

As noted above the payment of the special distribution should be treated in the hands of the policyholder as a normal policyholder benefit. The rules which apply to normal policyholder benefits are as follows:

- In general, a life policy is subject to tax when a claim or payment is made. A basic rate UK resident taxpayer generally pays no tax, whereas a higher rate UK resident taxpayer usually pays tax at 20%, unless the policy is qualifying, in which case there will be no tax due.
- If the Finance Bill 2009 is enacted some higher rate tax payers with income of over £100,000 could be paying tax at 30% or 40% depending on their marginal income tax rates.
- For pension policies the policyholder will usually be taxed on receipt of payment at their marginal rate of income tax. However, it should be noted that an unauthorised payment can suffer much higher rates of tax.

In the case of the PIP payments, Aviva has received confirmation from HMRC that, for UK tax resident policyholders holding life policies, apart from the unusual circumstances of the policy being held as a trading asset, the receipt of a cash PIP should be taxed as a capital gain rather than as a chargeable event receipt. Consequently, because section 210 TCGA statutorily excludes any capital gains arising on policies held by the original beneficiaries from the charge to tax, the cash PIP receipt should be exempt from tax.

However, for "second hand" life policies there could be some tax liability, although this will depend on the tax status of the recipient of the cash PIP.

We understand that for certain policies rather than a cash PIP being paid an amount, the bonus PIP, will be added to the current policy value. HMRC have confirmed that there will be no immediate tax liability on the policyholder when the bonus is granted. However, when the

policy is surrendered or a claim is made, the policyholder will be subject to tax under the normal rules as outlined above, i.e. an exempt policy will remain exempt and a chargeable policy will be taxable.

With regard to electing eligible pension policyholders, based on our understanding of the Scheme terms, we concur with Aviva's view that the PIP should meet the requirements of Statutory Instrument 2007/3532, The Registered Pension Schemes (Authorised Member Payments) Regulations 2007, such that it would not be treated as an unauthorised payment. There may be some rare circumstances where the payment may result in the Scheme breaching certain limits and the payment may then be treated as an unauthorised payment and subject to tax at rates between 40% and 55%. If the Finance Bill 2009 is enacted in its current form the 40% tax rate will be increased to 50% for some higher rate taxpayers.

5.03 Overseas policyholders

Aviva has obtained written confirmation from the Jersey, Guernsey and Isle of Man tax authorities that there will be no tax liability on PIPs. However, policyholders who are tax resident in other overseas jurisdictions will have to obtain their own tax advice regarding their tax position.

5.04 Further comments

We note that policyholders will not have the option to take their PIP as a policy bonus rather than cash. However, the draft Aviva Scheme provides that if there is an overriding tax reason the decision to pay a bonus rather than cash PIP is at the directors' discretion.

5.05 Ex gratia payments

The draft Aviva Scheme makes provision for ex gratia payments to be made. HMRC have confirmed that they will treat these on a basis wholly consistent with the cash PIP.

5.06 Tax position of the company

The pre attribution special distribution to policyholders of £2.1bn payable to the policyholders over a three year period should be allowed for tax purposes in AVLAP on the same basis as normal policyholder bonus distributions. We understand that this analysis is unaffected by the

Finance Bill 2009 changes because even if the legislation did apply these amounts will be funded out of taxable income.

Regarding the cash PIP, Aviva has advised us that the proposals are for the cash PIP to be paid either from the shareholder fund of AVLAP or from a group company. In these circumstances we do not consider there is a basis under current UK tax law and practice for a tax deduction. This is consistent with Aviva's stated intention not to seek a tax deduction.

In relation to the bonus PIP, it is our understanding that AVLAP will be claiming a deduction for the bonus PIP amount in both the NCI and GRB Case VI calculations and that HMRC have confirmed they agree with this treatment and Aviva has confirmed this is not affected by the Finance Bill 2009 changes.

The tax benefit arising from the increase in the reserves relating to the bonus PIP may be reduced by a second order effect. The driver of the GRB taxable profits allocated to shareholders is the amount of the GRB bonus compared to total bonus. Therefore, all things being equal, there will be a larger GRB profit if the PIP increases the bonus allocated to GRB in the NWPSF.

6.00 Ongoing management of the life funds – tax features

6.01 Tax frictional cost

The Aviva calculations used in calculating the value to the shareholders of the reattribution reflect the cost of tax on investment return while attributed assets remain in the AVLAP long term insurance fund. It assumes a tax rate of 6.9% is applied to the investment return. This is referred to as the tax frictional cost.

The calculation of the tax frictional cost is based on the 2006 BLAGAB proportion of the whole business post merger and an assumed mix of asset backing which takes into account the effective lower tax that applies to capital gains and UK dividends. We concur with this view that a tax friction cost arises. If the assets mix changes the frictional tax cost will change.

The detailed calculations of the 6.9% tax rate are set out in the following table.

Asset class	Proportion Held (%) [A]	Rate of return (%) [B]	Return [C] = [A]*[B]	Effective tax rate (%) [D]	Tax rate on 100 [C]*[D]	Comment on effective tax rate
UK equities	41.00	7.60	3.12	5.92	0.18	tax rate low due to tax free dividends & indexation relief
Overseas equities	9.88	7.60	0.75	10.26	0.08	tax rate low because of indexation relief AVLAP
Property	17.52	6.60	1.16	20.00	0.23	assumes no indexation relief on property
UK Govt. stock	11.26	4.79	0.54	20.00	0.11	
Other fixed interest	16.50	5.35	0.88	20.00	0.18	
Cash	<u>3.84</u>	4.10	<u>0.16</u>	20.00	<u>0.03</u>	
Total	100.00		[X] 6.60		[Y] 0.81	

(i) Effective tax rate [Y]/[X]	12.25%
(ii) Taxable BLAGAB proportion for the whole fund	57.50%
Overall calculated blended tax rate (i)*(ii)	7.04%
Blended tax rate used	6.90%

The blended tax rate of 6.9% applied to investment return arising from attributed assets assumes that Aviva holds the assets as ‘support capital’ for the insurance fund. If this were not the case the blended tax rate may increase as the investment return would not be allocated between taxable BLAGAB and exempt GRB categories of business.

In calculating the value to the shareholders of its offer to policyholders, Aviva allowed for this frictional cost. This is on the basis that if the attributed assets were removed from the AVLAP long term fund this frictional cost would cease.

During negotiations with Aviva, the policyholder advocate considered the arguments for a tax liability arising on attributed estate investment returns in the event attributed assets are removed from the AVLAP long term fund. Based on high level calculations we estimate that the corporation tax liability on such investment returns could be in the region of 23%, assuming the same mix of assets is held in a UK corporate entity. This 23% rate of tax replaces the lower frictional tax rate of 6.9%, in effect suggesting there is a ‘reduced tax rate’ benefit for Aviva by maintaining reattributed inherited estate assets in the AVLAP long term fund.

Also relevant to the tax frictional cost, Aviva, under the Scheme, cannot start to remove the reattributed inherited estate from the AVLAP long term fund until 2015. The policyholder advocate’s view is that the Aviva offer should be based on FSA guidance which permits the company to extract the reattributed inherited estate from the AVLAP long term fund after 3 years. In the policyholder advocates view, it is Aviva’s choice to hold the reattributed inherited estate in the AVLAP long term fund for longer, and this does indicate that the Company is happy to keep its capital in the AVLAP long term fund for longer than it is required to, and hence that there may in practice be a ‘reduced tax rate’ effect.

There are different views which can be taken as to whether the ‘reduced tax rate’ effect is a benefit to the shareholders. Various factors would impact on this and the following were discussed between the firm and the policyholder advocate:

- the tax profiles of investment returns arising on the reattributed estate;
- whether they the profits would be distributed or retained for further investment
- if the assets were retained would they be in a company subject to tax and at what rate, and
- the differing tax profiles of the Aviva group shareholders and their different tax attributes and their views of income or capital receipt in the light of these tax attributes.

Advice to the Policyholder Advocate on these issues from Professor Richard Brealey and Professor Julian Franks is included as an Annexe to Appendix 37.

We understand that these divergent tax rate and timing assumptions have been taken into account by the policyholder advocate in her recommendation to policyholders. However, it was not possible for the policyholder advocate to put a value on the reduced tax rate benefit because it was not possible to justify a value for this effect empirically. This does not mean that there is not a ‘reduced tax rate’ benefit just that it was not possible to justify the effect robustly enough in practice to merit including a valuation for it in the calculations.

6.02 Impact of the reattribution on the tax position of the merged funds

Aviva engaged KPMG Tax to prepare detailed tax models to ascertain the tax impact of the CULAC and CGNU Life funds merger and the reattribution of the inherited estate. As we did not have access to the whole of the tax model output or underlying data because Aviva did not consider it cost effective (as the model had been prepared by KPMG Tax), our work has been limited to a review of the summary report prepared by KMPG Tax and discussions with both Aviva plc group tax and KPMG Tax. During these discussions, we received explanations of the report and were provided with extracts of the model output.

We note the following points by way of an overview:

- The model horizon is 25 years, starting from 1 January 2006, based on the 2005 tax computations prepared for submission to HMRC for CULAC, CGNU Life and AVLAP;
- The models were based on actuarial data provided by the Aviva actuarial function and Aviva has confirmed the same data was supplied to LECG, although we have not been able to verify this;
- Three model runs were undertaken as follows:
 - On the existing position of CULAC, CGNU Life and AVLAP (model 1);
 - On the basis of a merged CULAC, CGNU Life and AVLAP company (model 2); and
 - On the basis of a merged company with a reattribution (model 3).

The tax effect of the merger was calculated by deducting the results of model 1 from the results of model 2 and similarly the tax effect of the reattribution was determined by deducting the results of model 2 from the results of model 3;

- The modelling work indicated that the merger and reattribution would result in a shareholder tax cost of £41m. As this amount is considered small relative to the overall incidence of tax, we understand Aviva does not propose to deduct this modelled tax cost from the inherited estate; and
- This modelling work has not been updated to take account of later year information.

6.03 Observations

In the early years of the model, the merged company has the benefit of being able to amalgamate a type of loss brought forward, called the excess needs, which reduces its tax liability. Absent the merger (i.e. if the CULAC and CGNU Life with-profit funds were taxed on a “stand alone” basis) loss relief would have been limited to the ability of each company to utilise its loss. CULAC excess needs would have run out by 2014 whilst CGNU Life’s would not have run out in the projected period. The NPV of this synergy benefit, as disclosed in the KPMG Tax report, is £21m.

This reconciles to the £41m cost noted above as follows:

	Merger only NPV in £m adverse / (favourable)	Reattribution only NPVs in £m adverse / (favourable)	Total effect in £m adverse / (favourable)
Needs basis	(21)	0	(21)
GRB allocation	5	25	30
BLAGAB allocations	34	(1)	33
Shareholder NC1 and PHI	(1)	0	(1)
Total	17	24	41

In determining the tax allocable to a with-profit sub-fund, there is a requirement to treat the with-profit sub-fund as a stand-alone company (“New Conduct of Business Source book”

(COBS) 20.2.27). Also in COBS there is the general principle that the policyholders should be treated fairly and this would include the allocation of tax between funds.

Other points to note are:

- (1) The Aviva models prepared by KPMG Tax have assumed that there will be no other losses generating value. However, KPMG Tax's summary report notes that losses are available and their value is estimated at £4m which Aviva estimate could be used before the reattribution.
- (2) The merger of the funds is likely to result in different base costs for capital gains tax purposes in respect of equity shares which both legacy (CULAC and CGNU Life) with-profit sub-funds owned at the time of the merger. Aviva has confirmed that the calculation of the benefit and the basis of its allocation will be subject to external audit review.
- (3) The PHI proportion, which determines how much long term insurance fund investment return is not taxed in the life assurance calculation of taxable profits, should be significantly higher in AVLAP compared to the pre-merger position in CULAC and CGNU Life. We believe this should result in a tax saving, and a one off tax accounting benefit at the time of the attribution. This merger effect has been taken into account in the calculation of the tax rate to be applied when valuing the reattributed inherited estate.

Based on our review of the KPMG Tax model summary report and discussions with Aviva and KPMG Tax, we have not identified any features of the model summary report which are inconsistent or unusual. However, as we have not had access to the whole of the model output or underlying data, we are unable to form a view as to the reasonableness of the modelled tax effect of the proposed transaction.

6.04 Prior year tax provisions

In the event that under or over provisions for tax in earlier years arises, the draft Scheme provides that the additional tax arising will be allocated by the AVLAP Board on the basis of

appropriate advice. Any reduction in tax will be allocated as far as practical to the appropriate sub funds in the same proportions as the business to which the relevant relief applies.

7.00 Scheme provision

These comments are based on our review of the draft Aviva Scheme dated 6th April 2009.

Both the OWPSF and the NWPSF will be treated as stand alone proprietary life companies.

This means that, absent any changes in the treatment of shareholder tax in a with-profit fund:

- (1) Shareholder tax relating to any distribution to shareholders will be charged to the non-core assets of the NWPSF (meaning shareholders will pay this cost), or the inherited estate remaining in the OWPSF (when policyholders, through their interest in the estate, will pay 90% of the cost);
- (2) The tax cost / benefit which arises from having the NWPSF and OWPSF in AVLAP will be charged / credited to the NPSF in the first instance. However, it should be noted that the directors of AVLAP have a duty to treat the NWPSF and OWPSF fairly if there are any substantial tax benefits which arise;
- (3) Any assets transferred by way of a contingent loan between funds will be credited with income return on the assets and reduced for an appropriate amount of tax to reflect any incremental tax that is being borne by the NWPSF or the inherited assets;
- (4) The allocation of tax between the various funds at the time of the transfer is set out in the Scheme. In outline the basis is:
 - Any transferred tax liabilities (excluding capital gains tax liabilities) will be allocated on the basis of the proportion of OWPSF and NWPSF realistic liabilities;
 - Capital gains tax liabilities and assets will be on the basis as set out in the AFH report; and

- Tax reliefs allocated as far as practical to the appropriate sub funds in the same proportions as the business to which the relevant relief applies;
- (5) In the draft Aviva Scheme shareholder tax is being charged to the non-core assets of the NWPSF. However, as these non-core assets are effectively reattributed estate assets “lent” to the NWPSF this should not impact the policyholders of the NWPSF; and
- (6) There is also a requirement under the draft Aviva Scheme, when considering the tax which is charged to the reattributed estate assets in the NPSF, to carry out some additional calculations on the assumption that the reattributed estate assets are part of the NWPSF. The tax charge of the NWPSF is then deducted from this calculation and the balance allocated to the reattributed estate assets therefore diminishing these assets.

AXA has previously reattributed an inherited estate and as such comparisons can be drawn between this and Aviva’s reattribution. In AXA’s case, the NWPSF only suffers policyholder tax, with shareholder tax being borne by the NPSF. This would seem to indicate that if you were starting from a position whereby there was no inherited estate, only the policyholder tax should be borne by the with-profit sub-fund.

Although it would appear that the mechanics of the two schemes are different, in our view the effect on policyholders should be the same, and we have noted in this Appendix that certain tax synergies or differences can arise as a result of the reattribution. COBS requires AVLAP to calculate the tax attributable to the NWPSF as if it were a stand-alone company. In any one year, the difference between this stand-alone calculation and the actual incidence of tax is either a synergy benefit or cost. Therefore, the draft Aviva Scheme provisions provide that, if there is a material difference in the tax, the Board of AVLAP should consider the allocation between all funds.

We have also reviewed tax provisions within the AFH report and the WPA report.

The principles as set out above in relation to the Scheme are reiterated in more detail in these reports. In particular the AFH's report sets out the tax allocation relating to capital gains and losses. This is that the tax relating to unrealised capital gains and capital losses and the deemed disposal gains and losses relating to collective investment schemes such as open Ended Investment companies(OEICs) will be allocated on the basis of the respective holdings in the sub funds and reattributed estate assets.

We have discussed in some length the position in the event that the FSA changes its view on the allocation of shareholder tax to the policyholders. Aviva has taken the view that there is sufficient protection in the rules. This is because if the allocation of tax between the sub funds is deemed by the AVLAP board to be inappropriate due to changes in the principles regarding fair treatment of policyholders rendering the original basis unfair then the board can change the methodology.

The policyholder advocate has taken legal advice and in her view the provisions currently in the Scheme do not protect non-electors. Under the terms of the Scheme, Aviva is permitted but not in terms required to amend the Scheme to give effect to such a rule change and the policyholder advocate considers this to be a clear detriment as there is no guarantee that if the FSA were to change its rules which permit the estate to bear the costs of shareholder tax, despite not allowing this charge to be made to asset shares, that this rule change would benefit the OWPSF. Her view is that this breaks a fundamental principle agreed with the FSA and the Company that non-electors should not be worse off as a result of there having been a reattribution. The policyholder advocate hopes that by the time the Scheme is before the Court that this principle will be upheld, and any rule change on shareholder tax will be replicated in the OWPSF.

8.00 Review of Aviva Tax Department's tax paper

8.01 Overall review of paper

The Aviva paper Appendix 34N considers each of the different taxes relevant to the reattribution. In this section we have cross referenced our comments to this paper.

Aviva Reference	Our Reference	Commentary
Section 2	5.0	This refers to the treatment of the PIP amounts. This section sets out the tax treatment of UK resident individual taxpayers and residents in Jersey, Guernsey and Isle of Man. The detail is similar to that set out in section 5.00 of this Appendix.
Section 3.01	4.03	This refers to the tax payable when the inherited estate is released from the fund.
Section 3.02	6.01	This details the tax payable on amounts which remain in the fund until release. This rate is dependent on the frictional tax rate.
Section 3.03	5.06	This explains the tax deductions which will be available at the corporate level in relation to the payment of the PIP.
Section 4	7.01	The summary of the Scheme provisions as regards tax.
Section 5	6.02	This explains how Aviva relied upon the modelling undertaken by KPMG Tax. We have covered this in some detail in our section.
Section 6.01	2.06	This explains the effective rate used by Aviva tax department.
Section 6.02	6.01	The section explains in more detail the frictional tax rate.
Section 6.03	2.04	This section looks at the tax in the realistic balance sheet.
Section 7	2.03	This section explains Aviva's view of the approach which the Policyholder advocate adopted in her negotiations with Aviva.

8.02 Commentary

We have reviewed this paper and have no additional comments. As noted in the body of this Appendix, different views can be taken as to the tax rates to be applied to the removal of the inherited estate from the with-profits funds and also who should incur the shareholder tax. We have commented on these aspects in section 4 of this Appendix.

Abbreviations

AFH	Actuarial Function Holder
AVLAP	Aviva Life & Pensions UK Limited
BLAGAB	Basic Life Assurance and General Annuity Business
CGNU Life	CGNU Life Assurance Limited
COBS	FSA handbook – New Conduct of Business Sourcebook
CULAC	Commercial Union Life Assurance Company Limited
FSA	The Financial Services Authority
GAAP	Generally Accepted Accounting Principles
GRB	Gross Roll-up Business
HMRC	HM Revenue & Customs
KPMG	KPMG LLP
LECG	LECG Limited
NPSF	Non-Profit Sub-Fund
NWPSF	New With-Profit Sub-Fund
OWPSF	Old With-Profit Sub-Fund
PB	Pension Business
PHI	Permanent Health Insurance
PBR	Pre Budget Report
PBR 2007	Pre Budget Report issued by the Chancellor of the Exchequer on 9 October 2007
PIP	Policyholder Incentive Payment
RBS	Realistic Balance Sheet
TCGA	Taxation of Chargeable Gains Act 1992
WPA	With-Profit Actuary