VERBOND VAN VERZEKERAARS

Guidance paper
Deferred Taxes and Solvency 2

1. Purpose

This guidance paper from the Dutch Association of Insurers describes possible approaches on how deferred taxes can be treated in the Solvency 2 balance sheet and Solvency Capital Requirement (SCR).

Deferred taxes can have a significant impact on the solvency ratio, warranting close attention from all involved.

In 2021/2022, a working group from the Dutch Association of Insurers developed this guidance paper. The paper is based on the EIOPA regulations on Solvency 2, as well as the Q&A from DNB and own experience from insurers in the Netherlands in dealing with the topics.

The intended audience for the guidance paper is three-fold:

- Insurance companies, who want to ensure a proper treatment for deferred taxes in the Solvency 2 reporting;
- Auditors, that are looking for a reference to assess practices in line with regulations;
- DNB, in its role as supervisor, who considers the financial strength of insurers.

The working group took into account the various practices at the participating insurers. Practices vary.

Regulation as well as models used for recoverability assessment of deferred taxes for insurance companies are inherently complex. This guidance document describes and discusses deferred taxes from three angles: solvency 2 valuation, actuarial projections and tax regulations and how these should be combined.

This guidance paper has two main parts: *theory* (chapters 2, 3 , providing for the impact and concepts of DTA and LAC DT), and *practice* (chapters 4 and 5, providing the practical guide how to calculate the recoverability assessment). In the Annex in chapter 6 we provide for the most relevant regulatory statements from Solvency 2 and on the tax regulations.

The guidance paper applies to both the standard formula and to internal models.

2. Role of taxes under Solvency 2

Deferred taxes are an item on the balance sheet of insurers. For both Life and P&C insurers[1], the impact can be significant.

For the total spectrum of Dutch Life and P&C companies, DNB publishes the balance sheets and solvency capital requirements. We consider the deferred taxes on the balance sheet (Deferred Tax Asset (DTA) or Liability (DTL)) and in the SCR, the Loss Absorbing Capacity of Deferred Taxes (LAC DT).

The figures in the table show the impact by the end of 2020.

Reported figures (€ mln)

	(1)	(2)	(3)	(4)	(5)
	DTA	**DTL**	**EOF**	**SCR**	**LAC DT**

[1] For P&C insurers providing policyholders with Dutch basic health insurers no taxation is required and therefore no LACDT is calculated.

Life	2.638	1.159	38.049	19.997	4.159
P&C	26	581	10.172	5.822	1.374

	(6)	(7)	(8)	(9)	(10)
	(3)/(4)	(3)/ ((4)+(5))	(6) – (7)	((3)-(1)+(2)) /((4)+(5))	(7) – (9)
	Base	**No LAC DT**	**Impact**	**No deferred tax**	**Impact**
Life	190%	158%	33%	151%	6%
P&C	175%	141%	33%	149%	-8%

The impact of LAC DT on the SCR ratio is significant. This applies both to Life and P&C, as well as for insurers using a (partial) internal model as for insurers using the standard formula.

For the DTA / DTL it is of interest that life insurers show a net DTA, most likely due to the long term nature of the liabilities that lead to a significant difference between Solvency 2 valuation and tax valuation of the technical reserves. For P&C insurers there is a net DTL. DTA and DTL have a sizeable impact on the solvency ratios, as is illustrated by the pro forma impact of putting them at nil. Removing the DTA and DTL is positive for P&C, caused by the net DTL position.
This paper is about DTA and LAC DT as part of the Solvency 2 reporting. It combines prescriptions from Solvency 2 as applied to the local (i.e. Dutch) tax regulations. We take the position that any legal requirement is a given, whilst interpretations may be up for challenge. The latter applies as well to the DNB Q&A or Good practice documents, that are a local interpretation of 'higher' legal requirements.

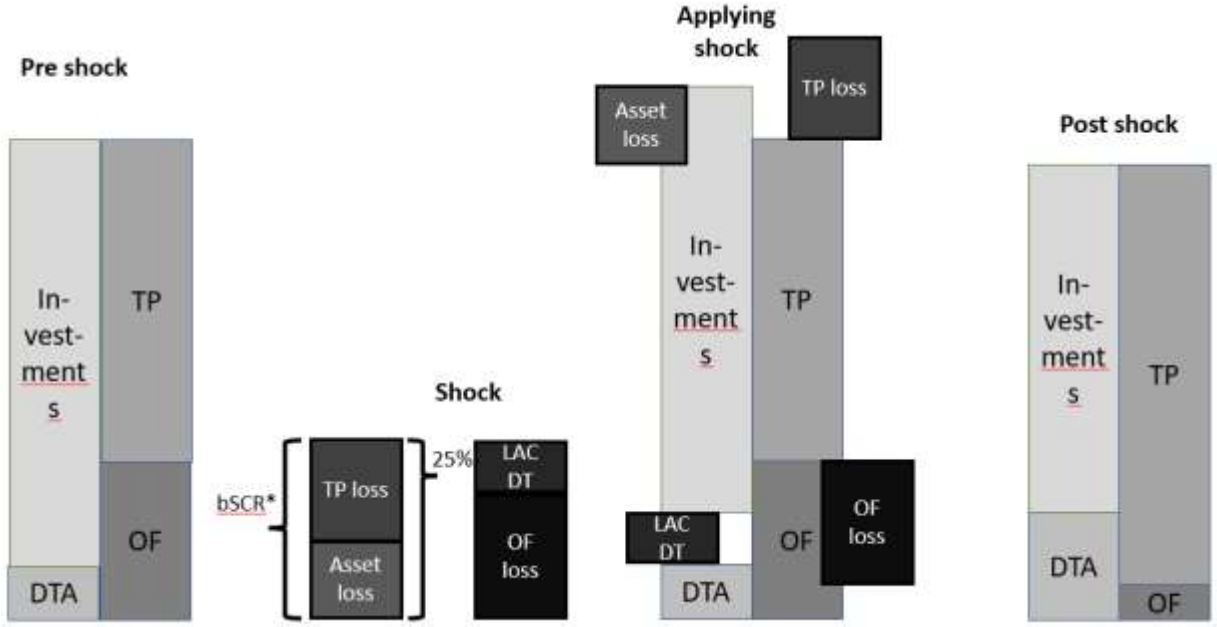
3. DTA, LAC DT, recoverability

DTA/DTL is a balance sheet position that can be sizeable. DTA stands for Deferred Tax Asset, that is a potential future claim on the tax authorities, where DTL stands for Deferred Tax Liability, a potential future payable to the tax authorities.

The D refers to the fact that the claim is not directly payable. A payable within the tax year will not be referred to as 'deferred', but as current.

Whereas DTA and DTL are items on the balance sheet, the LAC DT is not visible on the balance sheet. The LAC DT is based in Solvency 2 regulations in articles 103 and 108 of the Directive and article 207 in the Delegated Acts. The LAC DT is an item in the SCR calculation for insurers. The SCR reflects a 1-in-200 loss an insurer could incur, and the LAC DT is the reduction in those losses that can be cushioned by paying lower (corporate income) taxes after shock.

The graph below is a representation of how the DTA/DTL on the Solvency 2 balance sheet ('pre shock'), the bSCR* shock, and the post shock balance sheet relate.



DTA = Deferred Tax Asset OF = Own Funds TP = Technical Provisions

In this Guidance paper we will elaborate more on some steps. But this is the basis:

Pre shock: we reflect a simplified balance sheet of an insurer. In this case, there is a DTA on the balance sheet. On the balance sheet we will only include the DTA (or DTL) insofar as it can be substantiated.
Shock: the balance sheet is shocked with a bSCR* loss (bSCR* means the reported SCR minus the LAC DT). The shocks are translated to a direct cash loss, a decrease in the value of the assets or an increase in the value of the technical provisions. The losses to assets or liabilities add up to the bSCR*, meaning that they include diversification versus the sub SCR for the assets of technical provisions. The bSCR* shock will be translated in a loss in the Own Funds, and a possible effect on the net DTA after this shock. This effect on the net DTA (with an increase in the net DTA or a decrease in the net DTL) is the LAC DT.
Applying shock: the components of the losses will be attributed to the pre shock balance sheet. This leads to the **post shock** balance sheet.

The DTA in the post shock balance sheet will be assessed for recoverability. Only the recoverable part of the DTA will be included on the post shock balance sheet.

The LAC DT is the difference between the (recoverable) deferred tax position on the post shock balance sheet minus the (recoverable) deferred tax position on the Pre shock balance sheet. LAC DT applies at reporting entity level.

Recoverability assessment is needed to asses that a deferred tax-claim or deferred tax-obligation is sufficiently likely to be met. Both DTA and DTL are dependent on future tax profits and compensation possibilities. If the future tax situation shows that a DTA doesn't lead to tax savings (or that a DTL doesn't lead to extra tax payments), we define the DTA as non-recoverable or DTL as non-payable. On the balance sheet we show the DTA, DTL in so far as it is recoverable or payable. For the LAC DT a similar reasoning applies: the LAC DT as used in SCR reporting is only the recoverable LAC DT, or to be more precise, the recoverable LAC DT is defined as the difference of the recoverable DTA post shock minus the recoverable DTA pre shock.

3.1. DTA/DTL

3.1.1. Valuation differences

The DTA/DTL on the Solvency 2 balance sheet is based on valuation differences between the Solvency 2 balance sheet and the tax balance sheet. If these two would be equal, there would

be no DTA/DTL. The Solvency 2 balance sheet is based on market value[2], or models that are approximations of the market value. The corporate income tax value could be different. The DTA/DTL reflects the value of the tax receivable/payable on the valuation differences between the market value and the tax value of a balance sheet item.
As an example: suppose that the tax value of a bond is € 1.000, and the market value is € 1.400, the corporate income tax rate stands at 25%[3]. The revaluation of the bond is € 400. However, if the bond would be sold directly, a tax charge of 25%. € 400 = € 100 would be due. In the Solvency 2 balance sheet the bond is carried for the market value of € 1.400, and a DTL (=future payable to the tax authorities) of € 100 would be reflected. As a consequence, the revaluation leads to an net increase of the own funds with € 300.

Solvency 2 requires insurers to put all items on the balance sheet at market value. So for all items where the market value differs from the tax value, a DTA/DTL arises. There will be no arise of a DTL/DTA in case of share participations of 5% or more. Due to the participation exemption the difference is tax exempted (permanent item).

The rise of the DTA/DTL holds also for the technical reserves. The difference in tax value and market value is based on all items that are reflected in the Solvency 2 valuation, like the Risk Margin, the valuation curve, the best estimate assumptions, etc. The difference in the value of the technical reserves leads to a DTA if the Solvency 2 value exceeds the tax value.

The DTA/DTL is a reflection of valuation differences and unused tax losses, so subsequent changes in valuation will also directly impact the DTA/DTL position. As market values are volatile, the DTA/DTL is.

3.1.2. Netting and Tiering

Solvency 2 allows for the DTA/DTL on the balance sheet, and by doing so it impacts the own funds. The own funds are the basis of the assessment of the solvency of an insurer, comparing the available own funds with the required own funds (SCR). The DTA/DTL position on the balance sheet gets a special treatment in the calculation of the own funds that are the basis for the solvency assessment, the eligible own funds for the SCR, or the eligible own funds to cover the SCR.

In the calculation of the eligible own funds to cover the SCR, the Directive/Delegated Acts state that the SCR can be covered with not more than 15% of Tier 3 instruments. The net DTA is recognised as a Tier 3 instrument, meaning that for the calculation of the eligible own funds to cover the SCR, the net (recoverable) DTA/DTL is included on the balance sheet insofar as it does not exceed 15% of the SCR. As a consequence, a net DTA exceeding 15% of the SCR leads to a less attractive balance sheet profile, as part of the assets is not used to be included in the solvency ratio.

For the MCR assessment no DTA or DTL is allowed, as Tier 3 capital components are not included in the eligible own funds to cover MCR.

3.2. LAC DT

The LAC DT reflects the reduction of the SCR because SCR losses could be compensated with future tax benefits and/or carry back (reversal of previous paid taxes). The graph at the start of this chapter illustrates the concept of the LAC DT. It is the part of the bSCR* loses that can be compensated by lower tax charges in the years to come or repayment of previously paid taxes.

The LAC DT is calculated as the difference between the net DTA after the SCR shock and the net DTA before the SCR shock. The DTA on both (pre and post shocks DTA) should be assessed for recoverability.

2 Article 75, Solvency II directive. .

3 In this document, the tax rate of 25% is applied as this was the enacted tax rate in 2021. The enacted tax rate for 2022 has changed to 25.8%.

While we often refer to the recoverability assessment of the LAC DT, it consists of the recoverability assessments of two DTA positions.

3.3. Recoverability

The DTA is an asset (likewise, the DTL is a liability) caused by the difference in the valuation under Solvency 2 and tax. The DTA is an asset with value, as it reflects the claim caused by lower tax payments compared to the situation without the DTA on the balance sheet.

Gross DTA and gross DTL (gross, meaning before the recoverability assessment) represent (potential) future tax savings and tax increases respectively. To calculate the 'real' (recoverable) value of these tax savings/increases, one has to compare the future tax payments based on the balance sheet *with* the DTA/DTL with the (fictitious) future tax payments based on the same balance sheet *without* DTA/DTL. After all, it is this difference in future tax payments that determine the 'real' value of the DTA/DTL and this difference stems directly (and only) from the existence of the DTA/DTL on the balance sheet. We note that the reversal scheme of the DTA and the DTL should be developed with sufficient granularity.

It can easily be shown that the following holds regarding the *nominal* value of the net-DTA (which can, depending on the sign, effectively also be a net-DTL):

Nominal net-DTA = Tax% x Sum of future SII-income -/- Tax% x Sum of future fiscal income

Based on the paragraph above, the *recoverable* value of the net-DTA (/net-DTL) can be written as follows:

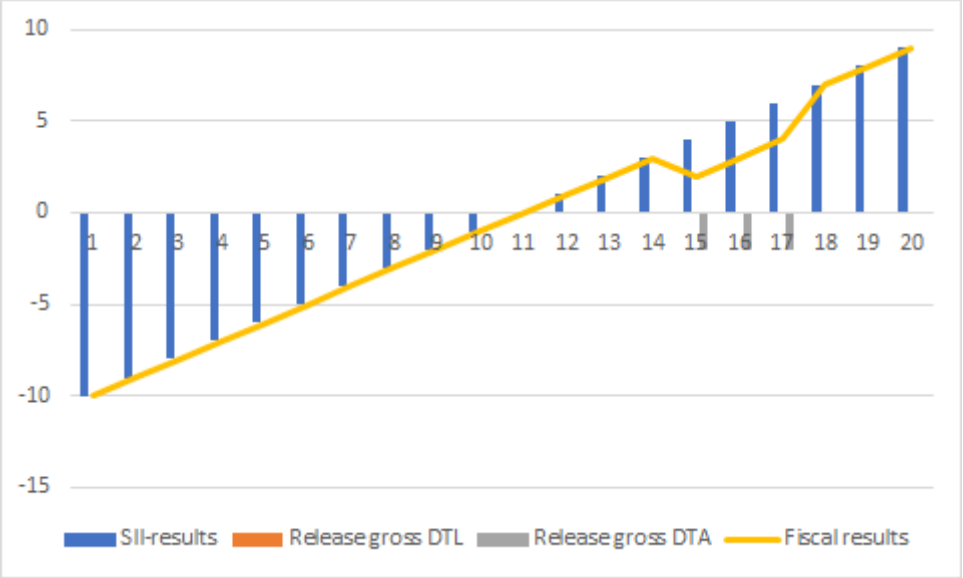
Recoverable net-DTA = Tax payments on future SII-income -/- Tax payments on future fiscal income

At first, the formulas for the nominal net-DTA and the recoverable net-DTA look similar. In fact, when under both the SII-framework and the fiscal framework there are (after the application of loss carry forward and –backward) no years with non-compensable losses, both formulas give the same result and hence the recoverability of the net-DTA is 100%. However, when there are years with non-compensable losses under the SII and/or fiscal framework, the recoverability of the net-DTA (again: which can – depending on the sign – also be a net-DTL) may deviate from 100%.

In theory, the recoverable value of a net deferred tax position (be it a net-DTA or net-DTL) can vary between the *gross*-DTA and the *gross*-DTL. The following graphs explain this in more detail.

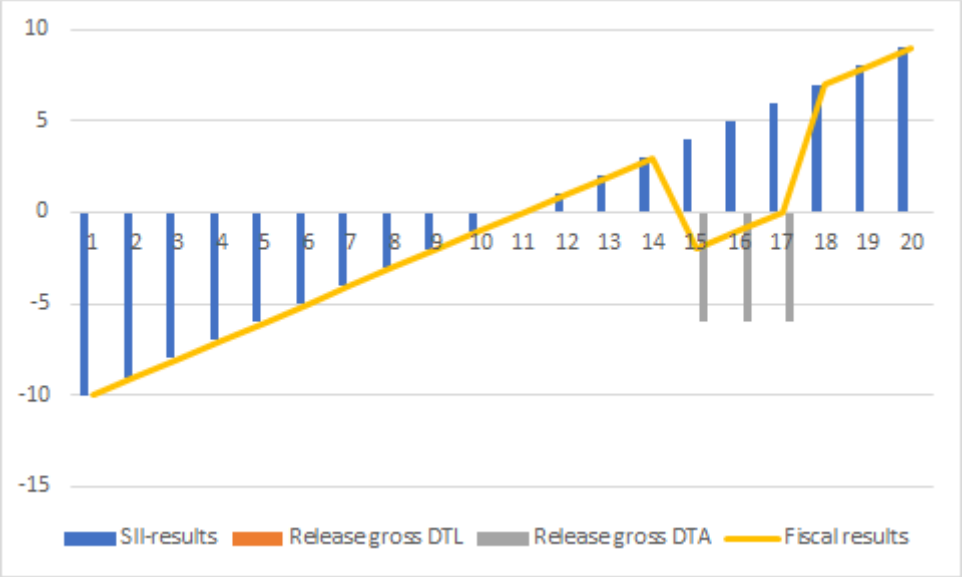
In the example-graphs below, the blue bars show the future SII results (so without the release of DTA and DTL). For the sake of simplicity, we disregard the possibilities of carry-back and carry-forward of losses. The red bars show the release over time of the gross DTL and the grey bars show the release over time of the gross DTA. Finally, the amber line shows the future fiscal results (= the sum of the blue, red and grey bars).

Situation 1: Gross DTA is fully recoverable



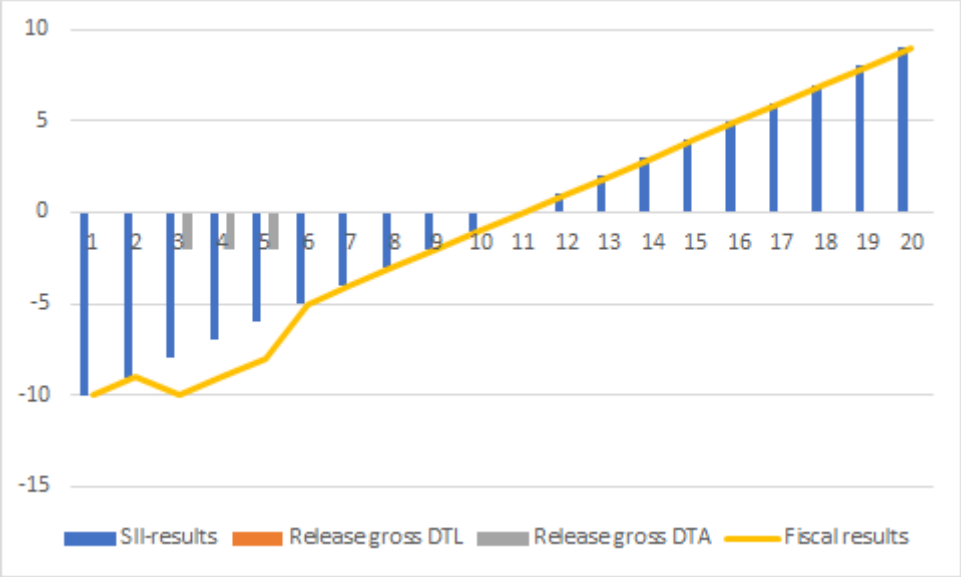
In the graph above, there is no gross DTL and there is DTA-release in years 15, 16 and 17. Because *without* the DTA-release (the blue bars), the profits in years 15, 16 and 17 are larger than the DTA-release (grey bars), the DTA is 100% realisable (the DTA can be fully recovered because the related tax savings potential is fully realized).

Situation 2: Gross DTA is partially recoverable



In the graph above, there is no gross DTL and there is DTA-release in years 15, 16 and 17. Because *without* the DTA-release (the blue bars), the profits in years 15, 16 and 17 are smaller than the DTA-release (grey bars), the DTA is less than 100% realisable (recoverable). The non-recoverable part of the DTA equals those values of the amber line (fiscal results) that are negative in year 15, 16 and 17. These parts are non-recoverable because they do not lead to any tax savings.

Situation 3: Gross DTA is fully non-recoverable



In the graph above, there is no gross DTL and there is DTA-release in years 3, 4 and 5. Because *without* the DTA-release (the blue bars), the profits in years 3, 4 and 5 are already negative (and hence even without the DTA-release no tax is to be paid over those years), the DTA-release (grey bars) doesn't lead to any savings in the tax payments: after all, also after the DTA release the tax to be paid over the years 3, 4 and 5 is still zero. Because the DTA doesn't lead to any future savings on tax payments, the DTA is 0% realisable (recoverability = 0%).

In summary, the realisable (recoverable) value of the gross DTA can vary between 0 and 100%. Of course, the same three graphs can be made with a gross DTL instead of a gross DTA and one can easily see that also the realisable (payable) value of the gross DTL can vary between 0% and 100%, depending on the timing of the DTL-release compared to the timing of the SII-results.

Given the fact that the realizable value of both the gross DTA and the gross DTL can vary between 0% and 100%, one can conclude that the realizable value of the net-DTA (again: which can – depending on the sign – also be a net-DTL) can in theory vary between the gross DTA and the gross DTL. Because in practice, the release of the gross DTA and gross DTL are not fully separated in time, the SII-results are more stable than shown in the (exemplary) graphs above and because of the possibilities of carry-back and carry-forward of losses, these extreme values will seldom materialize on the balance sheet of real existing insurers.

4. Projecting the balance sheet

Any recoverability assessment is based on a projection of the tax profits, using the prevailing tax regulations. The projected tax profits will be based on a projection of the balance sheet of the insurer during its run off or for a pre-determined period of time.

The basic relation is:

+ Solvency profitability stream
+ DTA/DTL depreciation or reversals
= Tax profit stream

4.1. Projection for recoverability assessment

The recoverability assessment considers the possibility to compensate tax losses with available tax profits. The compensation takes into account the tax legislation, considering the possibility to carry losses to the future and past, and possible (tax planning) management actions to get a more favorable outcome of the tax compensation.

Step 1: Starting solvency 2 balance sheet
The start of the recoverability assessment consists of the Solvency 2 balance sheet, and all information of the tax balance sheet at the same date. For the tax balance sheet it should be known what is the tax value of all items on the balance sheet, and available tax losses from the past.

Step 2: Project the solvency 2 balance sheet
The initial solvency 2 balance sheet is projected for the run off period of the insurer. The Solvency 2 balance sheet will provide for the possibility to pay dividends, starting from a certain capitalization. The projection of the Solvency 2 balance sheet needs to take specific elements into account like the run off from the risk margin, the effect of the valuation curve required to be used for insurance liabilities (UFR, VA, CRA) and the investment strategy.

Step 3: Translate into tax projection
The projected Solvency 2 balance sheet is translated to a projection of the tax balance sheet. This can be done by projecting the initial DTA and DTL from the Solvency 2 balance sheet. The projected DTA/DTL run off defines the tax value, so the depreciation scheme for the DTA and DTL should be constructed, being consistent with the projection of the underlying balance sheet items.

The outcome of the process is the projected tax balance sheet, allowing to determine the taxable profits and losses in the projection period.

Step 4: Assess tax implications and use management intervention
The projected results of the Solvency 2 balance sheet and of the tax balance sheet from step 3 are the basis to assess the taxes payable, using existing tax recoverability rules and tax information (like previous unused tax losses). If the pattern of tax profits and losses leads to the impossibility to use all losses, management actions can be used to introduce a more favorable tax projection. These management actions should adhere to certain basis requirements, but are a reflections of tax management actions that are used by insurers to prevent unwanted outcomes. The management interventions are based on existing legislation and tax practices.

Step 5: Consider if the DTA/DTL depreciation led to tax effects
In so far as the release of the (gross) DTA and DTL from the Solvency 2 balance sheet impacts the taxes to be paid they are considered realizable(meaning *recoverable* where it concerns the DTA and *payable* where it concerns the DTL). If there is no impact it is non realizable.

4.2. Future investment returns
The projection of the profits should include any form of investment returns. For LAC DT purposes article 207 provides guidance on the rates to be used post shock. Article 2c (c) states as default option that the base should be a return projection based on the risk free rates as enclosed in the risk free rate, unless there is credible evidence of likely returns in excess of those rates.

It should first be noted that most insurers have investments on their (tax) balance sheet which yield higher returns than just the risk free rate. These investments are part of the business model of insurers. In order to provide evidence on the excess returns of these investment, as a basis, insight could be provided into the different types of investments, showing which asset categories the investments are part of, what returns will be earned in run off, and the historical losses caused by credit events.

The excess returns used for the different asset categories could be aligned with excess returns used in other internal frameworks. One could think for example of capital management projections, medium term planning (projections), and scenario generators. In general, for example credit spreads, are based on the current level of credit spreads minus allowance for defaults/credit losses. For the existing asset book, the yield at valuation moment seems a good starting point. For reinvestments the current yields can be taken as a (realistic) base case, or a long term average yield observed over a long period. A combination is also possible, e.g.

depending on the moment of re-investment. In addition to the base case, additional prudency will be dealt with in the implementation of uncertainty (below).

4.3. New business and renewals

New Business will be part of the normal business planning. Profits from new business can sustain the profitability over the projection period. The relevance of the support from new business is stronger for P&C companies than for Life insurers; for the latter, the taxable profit from new business will emerge over a longer period than for P&C companies. In the business plan, insurers will have included the premiums, claims, expenses and investment returns the insurer is expected to obtain from existing policyholders and new policyholders (EIOPA assumes renewals to be part of the new business definition).

Regarding the realizability assessment of deferred taxes on the Solvency 2 balance sheet, the time horizon with respect to the inclusion of new business is not limited to the business plan period or a maximum of 5 years as required for the post-stress assessment with appropriate assessment of the uncertainty as time progresses.

4.4. UFR drag and LTGA corrections

As mentioned in chapter 4.1, the projection of the Solvency 2 balance sheet acts as a basis for the tax projections that – in turn – are necessary for the assessment of the realizability of the DTA/DTL on the Solvency 2 balance sheet (be it before or after shock). This Solvency 2 balance sheet has to be drawn up in conformity with the Solvency 2-regulations, among which the technical provision-specific regulations regarding the UFR and the LTG-measures (e.g. VA, CRA and transitional measures[4]).

When projecting the Solvency 2 balance sheet, assumptions have to be made about - among others - the future development of risk free interest rates, as these rates e.g., affect the future Solvency 2-ratios and the level at which fixed income assets can be reinvested during the projection of the balance sheet. Given the fundamentally unpredictability of future interest rates, the assumption that future market interest rates follow the forward curve seems an acceptable starting point. After the construction of future interest rate curves based on (market) forwards, for each future point in time the prevailing Solvency 2 curve can be constructed by applying the UFR and relevant LTG-measures. This is in line with the concept used in the DNB 'Nationale Staten' to construct future Solvency 2 interest rate curves. The level of the UFR is remeasured every year, which can be included in the Solvency 2 projection. However, concepts like the UFR are not part of the taxable profit calculation. Including it in the projection of the Solvency 2 profitability leads to the requirement to include an adapted release of the DTA/DTL compensating the effects on the taxable profit projection in the fiscal framework.

The previous paragraph assumes that the run off of the UFR and LTG-measures are taken into account when projecting future results. This implies that in the projection of the Solvency 2 balance sheet the (over time diminishing) impact of the UFR on the Solvency 2 profits and losses is considered: after all, the impact of the UFR-drag is notably significant in the initial years of the projection. The same holds – mutatis mutandis – for the LTG-measures.

Having said that, it is clear that UFR and LTG-measures are purely Solvency 2 constructs that are not recognized under tax-laws, cannot act as a source of profitability and as such should not have an impact on the projections of future income in the fiscal framework. In other words: in a free-running (= without ratio-dependent capital inflows or outflows) projection model, the mere existence of the UFR or the LTG-measures should not have an impact on the projection of future income in the fiscal framework.

Regardless of the framework (Solvency 2, IFRS, etc.), a hypothetical free running projection of the future tax results can be obtained by projecting the balance sheet in that specific framework, including the release of the (framework-specific) gross DTA and gross DTL. With a correct

[4] In the Netherlands no Matching Adjustment is used.

model, the resulting future tax results are independent of the framework (e.g. Solvency 2 or IFRS) on which the projection of these tax results is based.

From the paragraphs above one could conclude that the starting point for a projection of taxable results could also be a Solvency 2 balance sheet without UFR and without LTG-measures (and consistently adapted DTA). This is – in fact – correct, but only under the assumption of a free-running projection (as explained above: this means without ratio-dependent capital inflows or outflows).

In practice however, there will be ratio-dependent capital flows, e.g. dividends that are paid as soon as the ratio exceeds a certain threshold[5]. The size and/or timing of these capital flows affect the size of the investment portfolio at the moment of such a capital-inflow or -outflow and hence the projection of the taxable profits arising from that portfolio from that moment on. Through this mechanism, the existence of the UFR and LTG-measures affect future capital flows (e.g. dividends) and hence the projection of fiscal income of the insurer. It is because of this (more or less second order) impact, that the UFR and LTG-measures cannot be fully neglected when projecting the Solvency 2 balance sheet.

Example of tax-neutral effect of UFR-drag

An insurer has constructed the following projection of its Solvency 2-balance sheet and its resulting fiscal income:

t	1	2	3	4	5
Solvency result excl UFR-drag	100	100	100	100	100
UFR-drag	-12	-10	-8	-6	-4
Solvency result incl UFR-drag	88	90	92	94	96
DTA-release from UFR	12	10	8	6	4
DTA-release from other sources	-20	-17	-14	-11	-8
Future fiscal income	80	83	86	89	92

In the table above, one can see that the UFR-drag is - by definition - exactly mirrored by the release of that part of the DTA that stems from the UFR. This means that future fiscal income can also be projected as if the UFR doesn't exist. See table below where both the UFR-drag and DTA-release stemming from the UFR are set to zero:

t	1	2	3	4	5
Solvency result excl UFR-drag	100	100	100	100	100
UFR-drag	0	0	0	0	0
Solvency result incl UFR-drag	100	100	100	100	100
DTA-release from UFR	0	0	0	0	0
DTA-release from other sources	-20	-17	-14	-11	-8
Future fiscal income	80	83	86	89	92

Below the line, both tables show the same future fiscal results. Note that there is a difference in the Solvency-result (3rd line in the tables). This means that when the model isn't 'free-running' the balance sheet, but contains Solvency-level dependent capital flows (e.g. dividends), those dividends might be paid earlier in the projection where the UFR-effect is set to zero (= second table).

Notably the drag of the UFR is very time-dependent (not evenly distributed over time): in the initial years of the projection the depressing impact on solvency is relatively large. As a proxy however, the UFR-drag could be modelled as more evenly distributed in time. This

[5] This should be based on the by the AMSB approved pre-stress dividend policy of the insurer.

approximation leads to a more prudent (lower) outcome of the projection of taxable income. After all, a more evenly distributed UFR-drag leads to higher Solvency ratios in the initial years. This, in turn, will lead to earlier dividend payments (or: later capital injections) compared to the situation in which the UFR-drag is concentrated in the initial years. These earlier dividend payments lead to an earlier decrease in the size of the investment portfolio and hence to a lower projection of future fiscal results.

In case of ratio-dependent management actions (e.g., capital flows), a correct run off of the Solvency 2 balance sheet (including the run off of UFR and LTG-measures) leads to a correct timing of those actions in the projections of the Solvency 2 balance sheet and hence in the projection of fiscal income. This is the preferred solution. However, simplifications in the run off might be considered if these simplifications do not lead to demonstrably and materially more prudent projections of future fiscal income.

4.5. Risk Margin

Under Solvency 2, the technical provision must be valued at market value. On the basis of art. 3:67(2) Wft, this is the amount that would have to be paid if the insurance obligations were transferred to another insurer with immediate effect. This amount consists of a best estimate (the so-called 'Best Estimate Liability') and a risk margin. This risk margin serves as compensation for making available equity capital ('Cost of Capital').

The Best Estimate Liability will be sufficient to meet the insurance obligation of the insurer, the run off of the Best Estimate Liability funds the insurance claims and future expenses. The risk margin will be released with the run off of the corresponding portfolio of policies, there are no losses covered by the risk margin, the release is a profit stream. When new policies are written, an addition to the risk margin will take place. As such, a continuous portfolio has a 'hard core' in the risk margin. In the case of a declining portfolio ('Closed Book'), the risk margin will expire corresponding to the expiry of the Best Estimate Liability.

The BWRV includes specific tax rules for the tax valuation of, among other things, the technical provision at life insurers. The BWRV does not include the possibility for valuation at Solvency 2 principles. So the risk margin is not part of any tax valuation.

A deferred tax position must be included on the Solvency 2 balance sheet for the valuation differences between the tax value and the Solvency 2 value, meaning that the risk margin will be part of these valuation differences. Since the risk margin is not recognized for tax purposes, this always leads to a deferred tax asset on the Solvency 2 balance sheet. If risk margin is released, then that is a Solvency 2 result. When the risk margin is released on the Solvency 2 balance sheet, the DTA-release that corresponds with the (in size changed) risk margin – and which is by definition exactly the opposite of the risk margin release on the Solvency 2 balance sheet – has to be included in the *tax* results. This implies that the impact of the risk margin release on the tax results, which is equal to the sum of the risk margin release on the Solvency 2 balance sheet and the corresponding – but with a opposite sign – DTA-release, is exactly zero. In other words: the risk margin release is only a Solvency 2 result and not a tax result.

The table below contains an example-calculation showing that fiscal results are indeed independent on the risk margin (assuming a free running balance sheet):

Example of tax-neutral effect of Risk Margin

An insurer has constructed the following projection of its Solvency 2-balance sheet and its resulting fiscal income:

t	1	2	3	4	5
Solvency result incl Risk margin	100	100	100	100	100
Risk Margin	-12	-10	-8	-6	-4
Solvency result excl Risk Margin	88	90	92	94	96
DTA-release from Risk Margin	12	10	8	6	4

DTA-release from other sources	-20	-17	-14	-11	-8
Future fiscal income	80	83	86	89	92

In the table above, one can see that the Risk Margin is - by definition - exactly mirrored by the release of that part of the DTA that stems from the Risk Margin. This means that future fiscal income can also be projected as if the Risk Margin doesn't exist. See table below where both the Risk Margin and DTA-release stemming from the risk margin are set to zero:

t	1	2	3	4	5
Solvency result	100	100	100	100	100
Risk Margin	0	0	0	0	0
Solvency result incl Risk Margin	100	100	100	100	100
DTA-release from Risk Margin	0	0	0	0	0
DTA-release from other sources	-20	-17	-14	-11	-8
Future fiscal income	80	83	86	89	92

Below the line, both tables show the same future fiscal results. Note that there is a difference in the Solvency-result (3rd line in the tables). This means that when the model isn't 'free-running' the balance sheet, but contains Solvency-level dependent capital flows (e.g. dividends), those dividends might be paid earlier in the projection where the Risk Margin-effect is set to zero (= second table).

4.6. Management interventions

Basis for the recoverability assessment is a projection during the run off of the insurance portfolio. It will result in a projection of profits under both the Solvency framework and the fiscal framework. As described in the chapter on the Dutch tax legislation, the tax rules lead to the possibility to have management interventions that will have an impact on the those profits. As these profits are used to consider if future compensation of tax losses is possible, such management interventions may be relevant in the assessment of the projection of taxable results. The use of management interventions in the projection may help in getting a favorable pattern of tax losses and profits.

In daily practice, the use of management interventions to ensure a favorable tax treatment is common. This is sometimes done in consultation with the tax authorities, and always using the tax legislation in force.

In the projection of the taxable profits for the recoverability assessment the working group mentions the following non exhaustive list of interventions. The preparatory crisis plan of an insurer may include these possible interventions:

- Sale of assets and/or derivatives: in general, assets are valued at amortized cost in the tax balance sheet. This means that a sale at prevailing market value of assets can lead to a tax profit or loss. The sale of specific assets (listed bonds, listed equity) can be arranged at a relatively short time-frame, and the sales price will be nearly equal to the quoted price. For less liquid assets (real estate, mortgage loans) the time until a sale may take longer and prices can deviate from the quoted market value.
- Recalculation of technical reserves: the BWRV sets the basis for the tax valuation of (life) insurance technical reserves at tariff rates. It allows for a recalculation. Such a decision can be used as a possible management intervention to shift taxable profits and losses over time. We note that such a recalculation needs approval from the tax authorities
- Cost reductions: in times of crisis, management may decide to reduce expenses. The expenses in the projected tax P&L will be based on the Solvency 2 assumptions on expenses for the portfolio, in general assuming a decline in expense level in line with the portfolio runoff. So cost reductions as management intervention in the recoverability assessment should be above the planned costs in the base assumptions.
- Recapitalisation: if solvency falls below a certain level a capital injection can restore solvency levels. A recapitalization will be done internally (by the parent company) or by external

shareholders. The latter is not allowed to be included in the recoverability assessment in the December 2020 DNB Q&A. For an internal recapitalization, the insurance company should ensure that the parent company is able to perform the capital injection.

If an insurance company uses one of these management interventions in the recoverability assessment, it should prove it is possible to use the instruments. DNB mentions the use of Article 23 of the Delegated Regulations as a requirement to use the recapitalization instrument. This article was written, among others, to ensure proper documentation of technical reserves. Article 23 provides that management actions need to be, among others, realistic and consistent. The proof of the possibility to use other instruments could be found in experience in the past or the inclusion of measures in other documents approved by senior management like the ORSA or Preparatory Crisis Plan (PCP). If management actions from the ORSA or the PCP are to be included in the post-shock assessment, then they should be assessed for effectiveness in the post-shock situation.

5. Post shock tax recoverability assessment

The recoverability scheme as presented in chapter 5 is generic. It can be used for recoverability assessments pre and post (SCR) shock.

For LAC DT, the post shock recoverability assessment defines the outcome. There are specific requirements on the post shock recoverability assessment.

5.1. Allocation of losses

The post shock recoverability assessment should be based on the recoverability assessment that would happen after a SCR shock (to be more precise: after a loss of the BSCR plus operational risk). This SCR is based on several losses as reflected in the SCR, combined to one figure using diversification. The loss has different sources, and may have different consequences on the tax projection. Some SCR losses will be incurred directly in the tax profits, and other SCR losses will evolve over time in the tax profits. So the allocation of the total (diversified) SCR losses to different sources is needed to have a correct recoverability assessment (post shock).

The loss, the bSCR*, must be allocated to the various balance sheet items. Therefore several steps and assumptions have to be made:

Allocation of all levels of diversification.

- The 'single equivalent scenario' (SES)[6] can be used for allocating the different levels of diversification. In the SES scenario all diversification is allocated to the individual shocks in such a way that the aggregation of all individual shocks equals the net BSCR and thus reflects a 1 in 200 scenario. The basic SCR was recalculated using a single scenario under which all of the risks covered by the standard formula occurred simultaneously.
- Linear: another way of allocating the diversification is linear.

Materialization and timing:

- The loss resulting from the bSCR* shock materializes directly on the Solvency 2 balance sheet, as opposed to the fiscal balance sheet. An insurer therefore takes into account for each individual part of the shock loss to what extent and when the loss manifests itself for tax purposes when substantiating the net DTA with future profits. Both the pattern and size over the projection horizon are important here.
- Shock losses on assets whose return is tax-exempt, such as certain equity interests that are exempt from corporate tax under the participation exemption, cannot be settled by the insurer with the tax authorities and for this reason directly lead to a reduction of the maximum LAC DT that can be achieved.
- Current loss or deferred loss. A current acute loss is the loss that immediately reduces the tax result in the year that the bSCR* materializes and a deferred loss is a loss that will only lead to a tax loss in the future if this is actually realised. An example of a deferred loss is a

6 https://register.eiopa.europa.eu/CEIOPS-Archive/Documents/Advices/CEIOPS-L2-Final-Advice%20SCR-Loss-absorbing-capacity-of-TP.pdf

loss caused by lower mortality rates; longevity risk. This is immediately observable in the BEL under Solvency 2 principles. However, no direct effect is visible on the tax balance sheet as it is based on the BWRV/fixed mortality rates. In the best estimate projection of the insurance payments and release of technical provisions the effect of the updated mortality assumptions will get visible, leading to lower tax profits in the (far) future.

5.2. Increasing uncertainty

The Solvency Delegated Regulation, art. 207 (2bis)(c) prescribe that after shock, insurers have to take into account the 'increased uncertainty' when calculating the recoverable value of the DTA (after shock). The wording '*increased* uncertainty' implies that there is also an uncertainty *before* shock. In other words: when calculating the recoverable value of the DTA – be it before or after shock – insurers have to take into account uncertainty and this uncertainty is assumed to be higher after shock compared to before shock.

It is recognized that after shock, uncertainty is (generally spoken) higher than before shock. However, this higher uncertainty is 'ceteris paribus'. After all, an insurer can (but does not have to) mitigate (higher) uncertainty by applying de-risking after shock in order to recover more quickly to a desired Solvency level within a reasonable time. In other words: even though uncertainty for the individual risk classes (equity risk, longevity risk, etc) may increase after shock, an individual insurer can mitigate this by changing the exposure to the various risks after shock, possibly leading to an even lower uncertainty level after shock compared to before shock.

The balance sheet of an insurer is subject to multiple sources of uncertainty: asset returns, mortality rates, policy holder behaviour, size and profitability of new business, etc. It is obvious that it is impossible to take all those uncertainties into account when calculating the recoverable DTA. For operational reasons, only the uncertainties that contribute most to the unpredictability of future profits should be included in the analysis. This can vary across insurers: e.g. insurers that are in runoff do not have to deal with uncertainty in new business. Some sources of uncertainty are however very probably industry wide, like asset returns and mortality rates.

It should be noted that *uncertainty* is something different than *prudency*, but they are connected. Indeed, introducing uncertainty in the calculations of the recoverable DTA might in some cases lead to a lower DTA-recoverability than based on 'best estimate only', but it cannot be excluded that in other cases it might lead to a higher recoverability.

There are various ways to account for uncertainty in the calculation of the recoverability of the DTA:

- The application of reduction factors on various recoverability-drivers in the recoverability calculation
- The application of multiple scenarios in which the relevant risks materialize and calculating a (weighted) average of the outcomes of those scenarios (possibly with an extra adaption based on expert judgement)

The methods described are conceptually not very complex, but of course the underlying assumptions when calculating e.g. the reduction factors or scenarios do matter.

- When an insurer opts for the reduction factor-methodology, it will have to underpin the size of the reductions. Moreover, because the methodology for taking into account uncertainty has to be equal for the DTA before shock and the DTA after shock, a reduction factor after shock has also to be underpinned and has to be higher than the one before shock to account for the increased uncertainty after shock. The reduction factor should also increase in time, to account for the increasing uncertainty.
- When an insurer opts for the scenario-methodology, it will have to underpin the various scenarios, based on the actual risks the insurer is subject to. This involves the *type* of risks, *size* of the scenarios and the *weights* attributed to the various scenarios when calculating the (weighted) average. Again, before and after shock the same methodology has to be used, so the type, size and weights of the scenarios have to be assessed both before and after shock, taking into account that after shock the uncertainty is higher. The scenarios could e.g. be based on 1:10 shocks, in which case the size could be 'reversed engineered' from

the 1:200 shocks as included in the SCR-calculation. The weight of the shocks should be determined accordingly: the lower the confidence level of the scenarios, the higher the weight and vice versa. The scenario should include a method to reflect the increasing uncertainty, for instance by an over time increasing deviation from the best estimate scenario.

Whether it is included by means of a reduction factor, a scenario-driven calculation or another methodology, uncertainty has to address the actual risks the insurer is exposed to, before and after shock:

Investment returns
Almost all insurers are exposed to uncertainty in investment returns. The level of uncertainty in the investment returns is among others dependent on the riskiness of the asset portfolio: a portfolio with only government bonds might be subject to a much smaller level of uncertainty than a portfolio with relative high levels of equity and property. Also the level of interest rate hedging or the sensitivity to reinvestments is a factor that could be taken into account when assessing the uncertainty of future investment returns.

Insurance Risk
Next to investment returns, every insurer will be exposed to insurance risk. The level of uncertainty that comes with this risk may be assessed in various ways: e.g., it can be based on the application of a reduction factor on the release of the risk margin or based on several scenarios in which – with a predefined confidence interval - life- and/or non-life risks materialize.

New Business Profits
In article 207 a limit of five years is set on the number of years that future sales can be taken into account when calculating the LAC DT. The risks involved with future new business is that size and/or profitability of this (max) five years of new business doesn't materialize. Beyond that horizon of 5 years maximum, a haircut applies to the profitability of the business.

5.3. Recovery
The SCR-shock may lead to a post shock SCR ratio below 100%. If this is the case, a holistic and realistic modelling of the balance sheet post-shock may also include modelling of the recovery in the future projection.

In the Solvency 2 Regulations, Article 207(2a.b) states that impact of the shock loss on the undertaking's current and future financial situation and on insurance product pricing, market profitability, insurance demand should be taken into account. Most of these which would already be taken into account in either the shock allocation or new business profit projections. As part of the 'future financial situation' also the recovery can be considered. Paragraph 2d states that the insurer may assume the implementation of future management actions provided these are compliant with Article 23. Apart from this, no specific requirements on post-shock capitalization or recovery are defined.

In considering the development of the post-shock balance sheet, management interventions and time until recapitalization an insurer may consider internal consistency with other assumptions made in internal models or consistency with capital generation projections. Additionally, the insurers Recovery or Preparatory Crisis plan or ORSA could be considered.

If the post shock solvency ratio is above 100%, the viability of the insurer after the shock can be assumed to be secured. If this is not the case, this doesn't mean that viability cannot be secured. E.g., an insurer can define alternative viability-after-shock criteria that can be used as basis to show that viability is met. As ensuring viability is also part of Preparatory Crisis and Recovery planning, insurers can draw upon these assessments to underpin plausibility of recovery, without directly including profits resulting from said planning insofar these profits would not be eligible under this guidance paper.

In these considerations, it should be kept in mind that conditional external recapitalization does not qualify for LAC DT purposes as it is not under the full control of the insurer post-shock (DNB

Q&A section 3.2.1). Section 3.2.2. states that internal recapitalization (within the Group) can be used, as long as it is ensured that the capital injection can be provided: '*The insurer has also included and documented the internal recapitalization after losses in its policy, for both the solo entity and the group.'*

Appendix: rules and regulations

In the determination of the DTA, DTL and LAC DT there are two main bodies of regulations. The combination of these regulations lead to the inclusions of the balance sheet items DTA, DTL and LAC DT on the balance sheet and in the SCR calculations of insurance companies. If regulations change, the outcomes on the balance sheet and in the SCR will most likely changes as well. We provide the existing regulations at the time of writing. The analysis in this Guidance paper would apply as well if the regulations change, though some specific interpretations could change following the change in the regulations.

The first regulations relate on the way how items should (not) be recognized on the prudential balance sheet of an insurer. These regulations are reflected in the Solvency 2 Directive and lower-level regulations. Solvency 2 uses IFRS as basis, but leaves less room for choices. Some of the Solvency 2 prescriptions are open, and have been made more specific for local use. This applies also to DTA, DRL, and LAC DT, where DNB issued specific guidance for Dutch insurers. The second set consists of the tax legislation. This is national legislation, made independently from prudential regulations. Tax legislation applies to all companies, and there are specific rules for insurance companies.

Solvency 2

Both DTA and LAC DT have a firm base in the Solvency 2 documentation. There are several places with relevant references how to deal with DTA and LAC DT, at different levels of the Solvency 2 legislative body. DNB is empowered by the Dutch Wet op het financieel toezicht (Financial Supervision Act) to interpret the Solvency II rules on LAC DT in the directive. According to the Lamfalussy process they are only allowed to interpret where EIOPA leaves gaps in its interpretations.

Level 1: Solvency 2 - Directive

Article 103 of the Solvency 2 Directive on the structure of the standard formula states the following:

> The Solvency Capital Requirement calculated on the basis of the standard formula shall be the sum of the following items:
> (a) the Basic Solvency Capital Requirement, as laid down in Article 104;
> (b) the capital requirement for operational risk, as laid down in Article 107;
> **(c) the adjustment for the loss-absorbing capacity of technical provisions and deferred taxes, as laid down in Article 108.**

In article 103, there is a reference to article 108 of the Solvency 2 Directive on the adjustment for the loss absorbing capacity of technical provisions and deferred taxes, which states the following:

> The adjustment referred to in Article 103(c) for the loss-absorbing capacity of technical provisions and deferred taxes shall reflect potential compensation of unexpected losses through a simultaneous decrease in technical provisions or deferred taxes or a combination of the two.
>
> That adjustment shall take account of the risk mitigating effect provided by future discretionary benefits of insurance contracts, to the extent insurance and reinsurance undertakings can establish that a reduction in such benefits may be used to cover unexpected losses when they arise. The risk mitigating effect provided by future discretionary benefits shall be no higher than the sum of technical provisions and deferred taxes relating to those future discretionary benefits.
>
> For the purpose of the second paragraph, the value of future discretionary benefits under adverse circumstances shall be compared to the value of such benefits under the underlying assumptions of the best-estimate calculation.

Next to these specific requirements for LAC DT all regulation regarding the scenario-based calculations of the SCR applies. Regulation regarding the Basic Solvency Capital Requirements

does not apply to LAC DT as LAC DT is not an element of the Basic Solvency Capital Requirements.[7]

Level 2: Implementing Measures (207)
Article 9 of the Delegated Regulation sets out the general requirements for the valuation of all assets and liabilities other than technical provisions:

1. Insurance and reinsurance undertakings shall recognise assets and liabilities in conformity with the international accounting standards adopted by the Commission in accordance with Regulation (EC) No 1606/2002.
2. Insurance and reinsurance undertakings shall value assets and liabilities in accordance with international accounting standards adopted by the Commission pursuant to Regulation (EC) No 1606/2002 provided that those standards include valuation methods that are consistent with the valuation approach set out in Article 75 of Directive 2009/138/EC. Where those standards allow for the use of more than one valuation method, insurance and reinsurance undertakings shall only use valuation methods that are consistent with Article 75 of Directive 2009/138/EC.
3. Where the valuation methods included in international accounting standards adopted by the Commission in accordance with Regulation (EC) No 1606/2002 are not consistent either temporarily or permanently with the valuation approach set out in Article 75 of Directive 2009/138/EC, insurance and reinsurance undertakings shall use other valuation methods that are deemed to be consistent with Article 75 of Directive 2009/138/EC.
4. By way of derogation from paragraphs 1 and 2, and in particular by respecting the principle of proportionality laid down in paragraphs 3 and 4 of Article 29 of Directive 2009/138/EC, insurance and reinsurance undertakings may recognise and value an asset or a liability based on the valuation method it uses for preparing its annual or consolidated financial statements provided that:
   (a) the valuation method is consistent with Article 75 of Directive 2009/138/EC;
   (b) the valuation method is proportionate with respect to the nature, scale and complexity of the risks inherent in the business of the undertaking; (c) the undertaking does not value that asset or liability using international accounting standards adopted by the Commission in accordance with Regulation (EC) No 1606/2002 in its financial statements; (d) valuing assets and liabilities using international accounting standards would impose costs on the undertaking that would be disproportionate with respect to the total administrative expenses.
5. Insurance and reinsurance undertakings shall value individual assets separately.
6. Insurance and reinsurance undertakings shall value individual liabilities separately.

Article 9(2) of the Delegated Regulation implies that Solvency 2 valuation principles follow the international accounting standards adopted by the European Commission to the extent that they comply with the Solvency 2 valuation principles, i.e. transfer value, in Article 75 of the Solvency 2 Directive. The adopted accounting standard for deferred taxes is IAS12, to be used to the extent that it complies with the Solvency 2 valuation principles.

Article 207 of the Delegated Regulations ‘Adjustment for the loss-absorbing capacity of deferred taxes’ provides input for the LAC DT assessment and calculations.

1. The adjustment for the loss-absorbing capacity of deferred taxes shall be equal to the change in the value of deferred taxes of insurance and reinsurance undertakings that would result from an instantaneous loss of an amount that is equal to the sum of the following:
   (a) the Basic Solvency Capital Requirement referred to in Article 103(a) of Directive 2009/138/EC;
   (b) the adjustment for the loss-absorbing capacity of technical provisions referred to in Article 206 of this Regulation;
   (c) the capital requirement for operational risk referred to in Article 103(b) of Directive 2009/138/EC.

[7] Art. 103, Solvency II directive.

2. For the purposes of paragraph 1, deferred taxes shall be valued in accordance with Article 15(1) and (2), without prejudice to paragraphs 2a, 2b and 2c of this Article.

2a. Where the loss referred to in paragraph 1 would result in an increase in the amount of deferred tax assets, insurance and reinsurance undertakings shall not utilise that increase for the purposes of the adjustment referred to in that paragraph unless they are able to demonstrate to the satisfaction of the supervisory authority that it is probable that future taxable profit will be available against which that increase can be utilised, taking into account all of the following:
   (a) any legal or regulatory requirements on the time limits relating to the carry-forward of unused tax losses or the carry-forward of unused tax credits;
   (b) the magnitude of the loss referred to in paragraph 1 and its impact on the undertaking's current and future financial situation and on insurance product pricing, market profitability, insurance demand, reinsurance coverage and other macro-economic variables;
   (c) the increased uncertainty in future profit following the loss referred to in paragraph 1, as well as the increasing degree of uncertainty relating to future taxable profit following that loss, as the projection horizon becomes longer.

2b. For the purposes of demonstrating that it is probable that future taxable profit will be available, insurance and reinsurance undertakings shall not apply assumptions that are more favourable than those used for the valuation and utilisation of deferred tax assets in accordance with Article 15.

2c. For the purposes of demonstrating that it is probable that future taxable profit will be available, the assumptions applied by insurance and reinsurance undertakings shall meet the following conditions:
   (a) new business sales in excess of those projected for the purposes of the insurance or reinsurance undertaking's business planning shall not be assumed;
   (b) new business sales beyond the horizon of the insurance or reinsurance undertaking's business planning and beyond a maximum of five years shall not be assumed;
   (c) the rates of return on the insurance or reinsurance undertaking's investments following the loss referred to in paragraph 1 shall be assumed to be equal to the implicit returns of the forward rates derived from the relevant risk-free interest rate term structure obtained after that loss, unless the insurance or reinsurance undertaking is able to provide credible evidence of likely returns in excess of those implicit returns;
   (d) where, without prejudice to point (a), the insurance or reinsurance undertaking sets a projection horizon for profits from new business that is longer than the horizon of its business planning, a finite projection horizon shall be set and appropriate haircuts shall be applied to the profits from new business projected beyond the horizon of the undertaking's business planning. Such haircuts shall be assumed to increase the further into the future the profits are projected.

2d. Insurance and reinsurance undertakings may assume the implementation of future management actions following the loss referred to in paragraph 1, provided that the provisions laid down in Article 23 are complied with.

3. For the purposes of paragraph 1, a decrease in deferred tax liabilities or an increase in deferred tax assets shall result in a negative adjustment for the loss-absorbing capacity of deferred taxes.

4. Where the calculation of the adjustment in accordance with paragraph 1 results in a positive change of deferred taxes, the adjustment shall be nil.

5. Where it is necessary to allocate the loss referred to in paragraph 1 to its causes in order to calculate the adjustment for the loss-absorbing capacity of deferred taxes, insurance and reinsurance undertakings shall allocate the loss to the risks that are captured by the Basic Solvency Capital Requirement and the capital requirement for operational risk. The allocation shall be consistent with the contribution of the modules and sub-modules of the standard formula to the Basic Solvency Capital Requirement. Where an insurance or reinsurance undertaking uses a partial internal model where the adjustment to the loss-absorbing capacity of technical provisions and deferred taxes are not within the scope of the model, the allocation shall be consistent with the contribution of the modules and sub-modules of the standard formula which are outside of the scope of the model to the Basic Solvency Capital Requirement.

Article 15 of the Delegated Regulation, which is referred to in Article 207 on LAC DT sets out the regulation for the valuation of deferred taxes on the Solvency II balance sheet:

1. Insurance and reinsurance undertakings shall recognise and value deferred taxes in relation to all assets and liabilities, including technical provisions, that are recognised for solvency or tax purposes in accordance with Article 9.
2. Notwithstanding paragraph 1, insurance and reinsurance undertakings shall value deferred taxes, other than deferred tax assets arising from the carryforward of unused tax credits and the carry-forward of unused tax losses, on the basis of the difference between the values ascribed to assets and liabilities recognised and valued in accordance with Article 75 of Directive 2009/138/EC and in the case of technical provisions in accordance with Articles 76 to 85 of that Directive and the values ascribed to assets and liabilities as recognised and valued for tax purposes.
3. Insurance and reinsurance undertaking shall only ascribe a positive value to deferred tax assets where it is probable that future taxable profit will be available against which the deferred tax asset can be utilised, taking into account any legal or regulatory requirements on the time limits relating to the carry-forward of unused tax losses or the carry-forward of unused tax credits.

Level 3: EIOPA Guidelines

Guidelines on loss-absorbing capacity of technical provisions and deferred taxes
A separate set of guidelines regarding the loss-absorbing capacity of technical provisions and deferred taxes has been published by EIOPA. Guidelines 6 to 14 relate to the calculation and recognition for the LAC DT adjustment.

Guidelines on recognition and valuation of assets and liabilities other than technical provisions:
Next to these guidelines on LAC DT, the guidelines 9 to 11 regarding deferred taxes in the guidelines on the valuation and recognition of assets and liabilities other than technical provisions are also relevant.

Guideline 9 - Deferred taxes – recognition and valuation Discounting deferred taxes
1.26. Undertakings should not discount deferred tax assets and liabilities.

Setting off deferred tax assets and liabilities on the Solvency 2 balance sheet
1.27. An undertaking should offset deferred tax assets and deferred tax liabilities only if, it has a legally enforceable right to set off current tax assets against current tax liabilities; and if the deferred tax assets and the deferred tax liabilities relate to taxes levied by the same tax authority on the same taxable undertaking.

Recognition and valuation of a net deferred tax asset
1.28. Where there are insufficient taxable temporary differences, which are expected to reverse in the same period as the expected reversal of the deductible temporary differences, the undertaking should consider the likelihood that taxable profits will arise in the same period as the reversal of the deductible temporary differences or in the periods into which a tax loss arising from the deferred tax asset can be carried back or forward.
1.29. When making projections of taxable profits and assessing the likelihood that sufficient taxable profits will arise in the future, an undertaking should:
   a) take into consideration that even a strong earnings history may not provide sufficient objective evidence of future profitability;
   b) take into consideration that the degree of uncertainty relating to future taxable profits resulting from expected new business increases as the projection horizon becomes longer, and particularly when these projected profits are expected to arise in periods beyond the normal planning cycle of the undertaking;
   c) consider that some tax rules can delay or restrict recovery of unused tax losses and unused tax credits;
   d) avoid double counting: taxable profits resulting from the reversal of taxable

temporary differences should be excluded from the estimated future taxable profits where they have been used to support the recognition of deferred tax assets;

e) ensure that when making projections of taxable profits, these projections are both credible and broadly consistent with the assumptions made for other projected cash flows. In particular, the assumptions underlying the projections should be consistent with those underlying the valuations of technical provisions and assets on the solvency balance sheet.

Level 3 ½

DNB Q&A and Good practises

On 8 December 2020, DNB published the DNB Q&A and Good practices, which replaces earlier DNB guidelines.

The Q&A reflects the way DNB translates the regulations in supervisory policy. It binds DNB: is an insurer complies with the Q&A, DNB will accept the practice. If the insurer uses an approach that does not comply with the Q&A, it should explain why its approach still satisfies the (higher) regulations.

The 'Good practice' parts in the document are suggestions how to implement the regulations. It is taken from practices that DNB has observed. However, other practices can satisfy the same requirements as well.

We will give a summary of the DNB Q&A:

2: Valuation deferred taxes on the Solvency II Balance Sheet

2.1: DTA and DTL can be compensated, provided that the timing allows for it. The compensation of the DTA and DTL should take account of tax compensation rules. Insurers can have separate DTA and DTL on their balance sheets

2.2: A DTA can only have positive value if it is likely that there are sufficient future tax profits to realize the DTA

- 2.2.1: Investment returns are a possible source of future profits to substantiate a DTA. The total projected market value profit is split in direct returns and valuation profits. The projected Solvency II investment returns are based on the risk free market rate plus a spread that takes future defaults into account
- 2.2.2: Investment returns post shock equal the risk-free interest rate unless there is credible evidence for surplus investment returns. Both in the pre and post shock investment returns there is uncertainty. This uncertainty applies to investment returns, but also on returns based on the technical provisions. The method used to reflect uncertainty in the DTA post shock should be equal to the method that is used for the DTA on the balance sheet.
- 2.2.3: new business can be included to substantiate future profitability. The risk neutral assumption is that new business will not provide a positive return. If an insurer assumes s positive return on new business, this could relate to investment returns or to technical profitability. If the projection horizon increases, there is an increased uncertainty on the future profitability, especially if it concerns a period after the business plan.
- 2.2.4: in the projection of future profitability the effects of the UFR drag are considered in line with the report of the UFR drag in the 'Nationale staten'. The impact from the LTGA measures it applies are also considered.

2.3: An insurer can include tax planning opportunities that are in line with existing tax legislation and consistent how it uses tax planning with the tax authorities

2.4: If an insurer is part of a fiscal unity, it can use profits and losses in other parts of the fiscal unity to 21substantiate a DTA, if timing allows so

2.5: in the projection of future profitability the insurer takes future capital repayments into account I line with the existing capital policy

3: Calculation LAC DT

An insurer calculates the LAC DT based on the difference of the pre and post shock deferred tax position. The shock is the bSCR*, meaning the bSCR plus the operational risk. The valuation of the post shock deferred tax position is in line with the previous

chapter. It applies both to insurers using the Standard Formula or a (Partial) Internal Model. Insurers are allowed to put the LAC DT at nil if calculations are too cumbersome.

3.1: In the assessment of the financial position post shock, both the situation (for instance regarding interest rat6e levels) as the financial position (for instance on asset allocatio0n) are considered. Diversification is considered when applying the losses to different SCR categories

3.1.1: there is no explicit requirement that post shock insurers should comply with the SCR or MCR requirements

3.2: Future Management Actions are allowed in the post shock assessment, provided that Article 23 is adhered to

3.2.1: External Recapitalisation is not allowed as Future Management Action in the post shock profitability assessment

3.2.2: Internal Recapitalisation from the Group can be included as Future Management Action, provided that the post shock financial position of other group companies is taken into account. The internal recapitalisation is included in a policy for both the solo entity and the Group

3.3: for the compensation of DTA and DTL due to timing, the same considerations are included as pre shock

3.4: Future profitability. There are further requirements on the assessment of future profitability post shock

3.4.1: Post shock investment returns can be used. For bonds and loans, a post shock increase in credit spreads is translated in increased (implied) default risk losses, such that the assumption post shock is not more positive than pre shock

3.4.2: Only if the insurer provides credible evidence that there are surplus returns, these may be included in the assessment. Assumptions post shock are not more positive than pre shock. This applies for instance to excess returns and the release of the risk margin. Increased uncertainty is included in the projection post shock. If an insurer applies reduction factors in the pre shock assessment, these reduction factors should increase over time, and post shock they should be higher. The way that an insurer uses to consider uncertainty should be consistent in the pre shock balance sheet valuation of deferred taxes and the post shock assessment

3.4.3: New business can be included in the assessment of future profitability. The base rules from the pre shock assessment apply. The profitability of New Business post shock is lower than pre shock, as the insurer includes increased uncertainty

3.4.4: the annual drag related to UFR and LTGA measurers can be the same as pre shock

3.5: tax planning may be applied, just like pre shock

3.6: LAC DT may not use the effects of fiscal unity

3.7: Also in the post shock assessment, in the projection of future profitability the insurer takes future capital repayments into account in line with the existing capital policy

4: Risk management, capital policy and reporting

4.1: the Risk Management of an insurer includes policies regarding the substantiation of the LAC DT, and the key functions (Risk Management, AFH) are involved in setting methods and assumptions. In the assessment of the deferred tax positions the observations and doubts are considered.
The insurer assesses the risks of the LAC DT valuation, considering the solvency and financial situation and risk management practices, especially regarding future profitability

4.2: in the SFCR there is a more detailed split of the DTA and a description of the assumptions used for the profitability projections. In the RSR includes a more detailed description

4.3: insurers document the assumptions, methods and calculations for the substantiation of the DTA and LAC DT in such a manner that they can be understood step-by-step

Dutch tax legislation
Dutch tax law applies to companies in general. This holds for nearly all elements described in this chapter. There is one specific set of regulation for insurance companies, the Besluit Winstbepaling en Reserves Verzekeraars (chapter adopted in wet op de Vennootschapsbelasting).

Tax rates
As per 1 January 2022, the standard rate of the corporate income tax in the Netherlands is 25.8%, with a step up rate of 15% applied at the first € 395.000 taxable profit. When in this document reference is made to profits and losses then this is limited to taxable profits and losses recognized within the tax jurisdiction of the Netherlands.

Tax revaluation of insurance liabilities
For tax purposes, the liabilities at a life insurer are valued at assumptions included in the pricing (tariff) of the product at issue. This means the liabilities are valued by using the original tariff rate based on historical interest, mortality rates and expense ratios at inception.
These basics result, in the current low interest environment and longevity development, to a materially lower valuation of the insurance liabilities for tax purposes compared with the Solvency 2 market valuation. On the valuation difference a deferred tax asset is recognised.
Tax regulations (Besluit Winstbepaling en Reserves Verzekeraars - BWRV) provide the option to revalue the insurance liabilities for tax purposes to a higher market value using actual tariff rates.
A revaluation to a higher market value for tax purposes will result in the recognition of a tax loss, leading to the recognition of the deferred tax asset in the year of revaluation. This realised deferred tax asset can be used to offset the taxable profits of the current year and as a tax loss carried forward in the upcoming years.
The option of revaluation is theoretically possible in any given year by management action as long as this revaluation includes all of the insurance liabilities and in total leads to a higher valuation for tax purposes. Revaluation requires approval of the tax authorities.

Tax loss compensation
When an (insurance) company reports a taxable loss at year end, then these losses can be used to compensate taxable profits in previous or future years, offsetting a deferred tax asset versus the current tax payable in those years. The tax loss compensation rules have changed per 1 January 2022.
Until that date, tax loss compensation was limited in time but with the full amount of future profits. Tax losses could be compensated with taxable profits of the previous year or to the maximum of one of the six future years.
As of 1 January 2022, tax losses can be compensated with the previous year and indefinitely in future years. However, the yearly amount of taxable profits available for compensation is limited to a maximum of 50% of the taxable profits exceeding the first one million of profits in that year. These new rules apply to all of the tax losses existing on 1 January 2022. By management actions it is possible to match taxable losses in the respective years with taxable profits.

Fiscal unity
Tax regulation provides for group companies to act as a single tax payer, the so-called fiscal unity or tax grouping. In general, a fiscal unity can be recognised when companies are directly or indirectly for 95% or more owned by the same ultimate shareholder. A fiscal unity is formalised by a written confirmation of the Dutch tax authorities.
In a fiscal unity the participating members are treated as one taxpayer, meaning that all taxable profits and losses of the members are offset to one net taxable result of the ultimate parent company.
Offsetting the taxable results will lead to a transfer of current taxes payable or tax losses caried forward with other member companies. This process and the applicable procedures must be regulated in a Tax Sharing Agreement to address the enforceable right as required in EIOPA-BoS 15/113 EN – Guideline 9, 1.29.
The offsetting of taxable profits and losses only applies when determining the recoverability of deferred taxes at the Solvency 2 balance sheet. When calculating the LAC DT, offsetting of taxable profits and losses within the fiscal unity cannot be applied but is required at a stand-

alone basis of the respective insurance entity as described in EIOPA-BoS-14/177 – Guideline 9, which relates to LAC DT. Article 1.28 states that the use of the tax transfers cannot lead to a higher receivable compared to the situation when it could not be transferred. This means that LAC DT cannot increase because of the use of fiscal unity.

Equalisation reserve
Tax regulations facilitate insurance companies, when meeting the requirements, to recognise an equalisation reserve resulting in a deferral of current taxation of taxable profits in any given year.
Applying this facility will result in the recognition of a deferred tax liability under Solvency 2.
Release of the amount recognised in the equalisation reserve is voluntary in any year by management action but is mandatory in a situation of tax losses.
In principle the equalisation reserve is recognised at the level of the parent company of the fiscal unity. However, with reference to article 15aj -4 a. of the Corporate Income tax code 1969, a company can decide in the tax sharing agreement to allocate the deferred tax liability to the respective insurance companies within the fiscal unity.

Tax valuation of investment assets
Tax regulations allow insurance companies to value their investment assets in general at cost or lower market value. For fixed income (e.g. bonds, loans) the minimum valuation is limited to the amortised cost value. As such, unrealised capital gains are deferred until actual sale whilst for non-fixed income instruments unrealised taxable losses are recognised when incurred. In practise, also management actions can actively trigger unrealised capital gains to be realised at any moment.

Reinvestment reserve
Tax regulation facilitates insurance companies to defer the taxation on profits realised on divestments of real estate investments. Under the condition that at disposal of real estate the intention to re-invest in other real estate and this intention is realised within the upcoming three years following the investment, then the taxable profit is deferred by reducing the taxable book value of this new acquired real estate. This reduction result in the recognition of a deferred tax liability. This deferred tax liability can be released at divestment of the real estate, in case successively the reinvestment reserve facility is not applied (again) or by management action.

Tax exempted investment income
When determining (deferred) taxable profits recognised to compensate tax losses within the same tax jurisdiction, at the Solvency balance sheet and in the LAC DT, a company should recognise tax exempted income as a result of the participation exemption on equity investments meeting the tax requirements. These profits do not lead to deferred or current taxes and hence cannot be used to substantiate the DTA or LAC DT.

Tax planning
The recognition of deferred taxes in the Solvency 2 balance and the LAC DT calculation is based on the underlying run off pattern of the respective tax positions.
However, this pattern can be optimised by management actions such as revaluation of insurance liabilities, release of equalisation reserve and reinvestment reserve or recognition of unrealised profits.

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