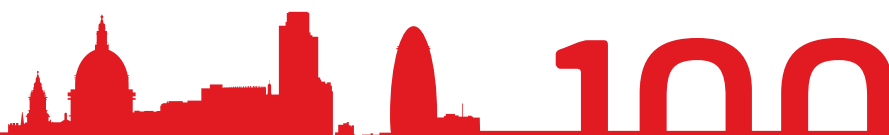




London Market Tax Policy Discussion Paper



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1. Introduction

The business of underwriting international insurance and reinsurance risks by companies and Lloyd's Syndicates domiciled in the UK has been significant for over 100 years.

The London Market (as this area of international insurance & reinsurance is described) has world class expertise in pricing and leading reinsurance and non-life risks; currently, it earns approximately £24.7bn in premiums per annum, an increase of 13 percent on prior year¹, against an estimated £27bn of capital² (2008).

In 2009 Lloyd's reported a profit for the market of £3.9bn from premium income of £21.9bn. The market capital for the period was £19.1bn.³

This paper is not referring to the UK domestic insurance or savings market – nor the life market overseas.

Yet due to the progressive tax disadvantages of underwriting risks by UK domiciled entities over the past 30 years many of the operating companies have established themselves in Bermuda and Switzerland. More recently, many UK holding companies have been transferring their domicile out of the UK tax net.

The cost to the Exchequer of the un-competitive tax treatment of these businesses is enormous.

It is recognised that the pressures facing the UK Economy are going to be huge; the political environment radically to reduce corporation tax to levels nearer 15 percent are unlikely for some time. Further, any proposals to make improved taxation provisions must demonstrate a high probability of increasing a net tax gain to the Exchequer.

Therefore, in this paper we set out a series of very specific tax provisions which we believe would create a compelling case both to retain the existing UK domiciled businesses – but more significantly would enable the UK actively to market itself to companies currently domiciled in Bermuda, Dublin and Switzerland to attract them to move to the UK.

We believe that there is a 'window of opportunity' to capture reinsurance business currently underwritten outside the UK as the political uncertainties of Bermuda and the US approach to taxation unfolds.

In setting out the proposed provisions we will attempt to 'cost' them in respect of the existing entities operating from the UK – and then make some assessment of the likely increase in business that could become attracted to a UK domicile together with the additional tax revenues generated.

We have assumed that the benefit of the proposals included in this paper will be in the form of increased economic activity in the UK rather than increased corporate tax receipts, we do not believe that the proposals would lead to a reduction in the corporation tax contribution to the economy. We understand that HM Treasury do not currently operate a "dynamic" economic model and therefore it will not be possible to estimate the impact on other (non corporate) tax receipts from the increased economic activity.

It is perhaps helpful to remind the reader that each Lloyd's syndicate is supported by one or a number of Members of Lloyd's; the syndicate is not itself an entity. Members of Lloyd's consist of companies, partnerships and individuals which provide the capital and are the insuring entities but with a commonality of interest via the Lloyd's Central Fund which stands behind a Member of Lloyd's should it fail.

Insurance, the UK economy and the London Market

The insurance industry is one of the key contributors to the UK economy. In 2006/07 the industry's contribution to the total tax take equalled £9.7bn of which £2.9bn was corporation tax⁴. The total Government receipts from taxation in 2006/7 were £516bn. Corporation tax accounted for £49bn of this amount⁵.

In 2008 the UK insurance industry employed 313,000 people⁶ of which approximately 50,000 were employed by the London Market⁷. The London Market accounts for approximately 12.5 percent of the UK insurance market in 2009⁸.

Much of the focus of the work of other industry bodies and aspirational policy documents is the UK life and pensions and retail general insurance industries. These elements of the UK insurance industry typically focus on UK consumers and individuals rather than business customers. The issues facing these parts of the industry are different to those facing the London Market which tends to be smaller in size (when considering the number of employees but not necessarily profitability), mainly focused on business customers and where a high percentage of insured/reinsured and risks are located offshore, the US market being particularly important. The London Market exports the majority of its services overseas and brings a huge amount of foreign premium into the UK.

¹ Insurance 2009 (Dec 2009), International Financial Services London. This number is likely to be prudent as the report states that it does not include premiums for UK domestic risks written by London Market participants. The expectation is that this domestic premium is worth approximately 5% of UK general insurance premiums in 2008 or £2.36bn.

² It is impossible to determine how much capital is employed in the London Market as the market is itself indefinable. The "Insurance 2009" report produced by International Financial Services London reports that the capacity (capital at Lloyd's in 2008 totalled £16.1bn. Lloyd's accounts for 63% of premium income in the London Market in 2008 resulting in £9.2bn arising in the company market segment. Assuming a greater amount of capital is required to write business in the company market than in the Lloyd's market, a prudent assumption would be capital requirements of 120% of premium income we derive a capital figure of £11bn thus £27bn overall. This again does not include UK domestic business written by London Market participants which based on comments in footnote 1 above may add another 10% to the capital of the London Market.

³ Lloyd's Annual Report 2009.

⁴ UK Insurance – Key Facts (Sept 2009), Association of British Insurers.

⁵ Economic and Fiscal Strategy Report and Financial Statement and Budget Report (March 2006) produced by HM Treasury.

⁶ ONS, Economic and Labour Market Review (Dec 2008)

⁷ Insurance 2009 (Dec 2009), International Financial Services London

⁸ Taking figures from the Insurance 2009 produced by International Financial Services London where total UK premium income is cited as being £215.3bn and we assume London Market premium

The number of companies participating in the London Market are more numerous than those operating in the life and pensions and retail general insurance space. The profitability of these companies fluctuates to a much greater degree than the other industry segments whose profits are less susceptible to catastrophes, tend to pay smaller amounts per claim (although experience a significantly greater number of claims) and where much of the profit comes not from underwriting but rather from the return on investments.

London Market participants focus on large commercial and specialist risks both as direct insurers and also as reinsurers (and through retrocession – the

reinsurance of reinsurance). London has a pre-eminent position in this global industry and has had since the seventeenth century. Lloyd's is at the centre of the global large commercial and specialist risk industry and attracts participants, capital and underwriting talent from around the world. The centralisation of talent and experience in London has also resulted in international insurance and reinsurance companies setting up operations here to write this specialist business through companies rather than through the Lloyd's market. These non Lloyd's insurance and reinsurance platforms are often referred as the Company Market, a term used throughout this paper.

2. The London Market, the current climate and the opportunity for the UK

Over the last ten to fifteen years the shape of the global large commercial and specialist risk market has changed. London is still a dominant force but with less power than it enjoyed in the past as offshore locations such as Bermuda, and more recently Switzerland and Ireland, have offered serious competition. Companies operating in this market are very mobile and it is very easy to move large amounts of capital, risks and profits with a single pen stroke on a reinsurance contract.

Capital to support the underwriting is key and access to new capital and maintenance of that already secured is one of the major issues facing all market participants. As a result it is vital for participants in the London Market to ensure that return on capital/return on equity is attractive for current and potential investors. Strict underwriting and investment discipline are key to ensuring this is achieved but removing as much as tax from the equation as possible is also one of the main ways companies in this market manage their competitiveness.

The current climate is one which offers the UK an opportunity to regain some of the ground it has lost to other jurisdictions, and particularly Bermuda, in recent years. Many companies located in Bermuda are considering their options as to where they should be headquartered and locate operating platforms. Bermuda has always been attractive from a tax perspective but this is now being challenged partly by the global clampdown on low tax jurisdictions, although Bermuda is now on the OECD white list, but also by the US who are developing legislation that impacts the payment of premiums to offshore insurers and reinsurers. In addition to the tax challenges Bermuda is experiencing a huge amount of pressure on its infrastructure and is considering a change to its regulatory environment

to coincide with the implementation of Solvency II in Europe. Companies located in Bermuda are looking towards Europe for a new home and Ireland and Switzerland are the favoured locations.

In addition to the possible redomicile of Bermudian headquartered insurers and reinsurers, those headquartered in London are also considering their options. As a result of the competitiveness arguments mentioned above, the directors of companies located here must consider as part of their fiduciary duties to the shareholders whether London is the right place to be.

The London 100 recently carried out a survey of senior executives in the London Market. The survey showed that from a non tax perspective the UK was the favoured domicile. The quality of the reputation of the regulator and market, access to capital and new business and the availability of skilled resource all make London the first choice location for this industry.

The area that all mentioned as the factor that made other locations more attractive than the UK was tax. Corporation tax on company profits was the most important element of the tax regime influencing the decision of where to locate a company followed by the overall nature of the tax regime and then the taxation of shareholders. Personal taxes were not seen as a key decision making factor.

If the tax regime can be improved, the UK could once again be the first choice location for this industry. The companies already located here would not look to locate elsewhere and companies located offshore may choose the UK over its European competitors as a new home. Our suggestions on the following pages are what we believe to be the key changes to the UK tax regime to attract this market onshore.

3. Proposed amendments to the UK tax regime

As noted above corporation tax was deemed to be the key element of the UK tax regime. Whilst a mainstream corporate tax rate of 15-17.5 percent was cited by many as a rate which would bring their companies to the UK we understand that this would currently be unachievable. Our focus therefore has been on ways that the effective tax rate (the actual tax paid as a percentage of the group's profit before tax) could be reduced to something close to this level for companies in this market whilst maintaining a headline corporation tax rate of 20-25 percent.

We have developed these suggested changes to the corporation tax regime with the following key design principles in mind:

- **It is desirable for groups to be parented in the UK and for the mind and management to be located here.**

In our view for the UK to remain as the home of the global large commercial and specialist risk insurance industry, the key decision makers need to be located in the UK and the strategic direction of the market as a whole needs to be determined in London. This will not necessarily give rise to more tax for the Exchequer but it will secure the contribution to the economy for many years to come. In 2009 it is estimated that 66 percent of London Market participants are foreign owned⁹;

- **The increase in corporation tax receipts for the UK economy derived from group's locating their head office and operating platforms in London as a result of the proposed changes will be dwarfed by the increase in other taxes (including income tax, national insurance contributions, VAT and council tax).**

This cannot easily be estimated as the knock on effect to the economy of additional UK employees is not limited to the income tax and national insurance that they pay on their salaries. We also understand that HM Treasury is currently unable to model this dynamic impact on the economy.

The Economic and Fiscal Strategy Report published at the time of the 2009 Budget indicated that corporation tax accounted for 7 percent of total tax receipts. Income tax and national insurance contributions accounted for over 48 percent. The remaining tax receipts were made up of VAT (13 percent), business rates and council tax (10 percent) and other taxes, including stamp duty, petroleum taxes, excise duties, etc. (22 percent).

It is therefore assumed that the main "prize" for the UK economy is associated personal taxes and the taxes levied as a result of the resulting impetus to the economy rather than substantially increased

corporation tax receipts; and

- **It is desirable for as much of the capital that supports the underwriting of the market as possible to be located in the UK. Locating the underlying capital in the UK will positively impact the wider UK economy through the likely increased use of UK based investment professionals.**

In addition locating capital in the UK will bring the capital within the UK regulatory regime and therefore impose stricter requirements and discipline than may currently exist, thus reducing risk in the industry overall

The results of the survey carried out by the London 100 would indicate that personal taxes are not a factor in making a decision as to where to locate a company and therefore have not been considered in detail in this report. It has been noted that announcements have been made as to the fact that the 50 percent tax rate announced in the 2009 Budget will remain for a period of time after the next general election but that it is not a policy that would continue for the long term. This seems to have been accepted by the London Market as necessary for now but we would recommend signalling a reduction in the top rate of income tax as soon as practical.

The market would welcome a reversal of the proposed increase in both employers and employees National Insurance Contributions which would add a significant amount to the cost of employing people in the UK

In addition the perceived attack on pensions is often cited as of more concern than the short term increase in the highest rate of income tax. Some comments regarding personal tax issues arising from individuals' participation in the Lloyd's market are included at 3(d) on page 10.

a) Shareholder taxes

Apart from the rate of corporation tax, the taxation of shareholders and the nature of the tax regime were highlighted by respondents to the survey as being the key tax decision making factors.

The UK regime for the taxation of shareholders/investors does not need to be amended in our view. The UK does not levy withholding taxes on dividends paid by UK parented companies to shareholders located offshore. This makes the UK an attractive location for foreign investors and therefore makes it easier for UK parented companies to raise new equity finance.

Switzerland imposes a withholding tax of between 15-35 percent on dividends paid to non-Swiss

⁹ Insurance 2009 (Dec 2009), International Financial Services London.

shareholders and therefore the UK would be seen as a more attractive location than Switzerland in this regard. Bermuda and Ireland do not impose withholding tax on dividends paid to non resident shareholders.

During the course of 2009 the UK corporation tax treatment of dividends received from overseas subsidiaries was amended to extend the tax free treatment previously applied to UK dividends. As a result the UK has become a more attractive location to locate a parent, or intermediate parent, entity.

b) The nature of the tax regime

Over the course of the last few years the perception is that HM Revenue and Customs (HMRC) have become less “user friendly”. The drive within HMRC has been to build relationships with the taxpayers such that issues are discussed in real time rather than waiting for the submission of a return but the attitude with HMRC, being pushed down from the top of the organisation, seems to be that all taxpayers are trying to plan around paying taxes and this taints the discussions.

Switzerland is often held out as an example of an attractive regime as there the Federal and Cantonal Authorities are open to dialogue, will negotiate on what is possible from a tax perspective and will give certainty on the treatment that a tax payer can expect.

We understand that the ability to “do a deal” on tax is something that is not on the agenda as a possibility for change and that is accepted by this group. However there are some lessons that can be learnt from the Swiss tax regime and attitude to taxpayers.

Firstly, the dialogue with the Swiss authorities give rise to certainty. The discussions that are had and the decision that is made usually give rise to a ruling as to how something should be treated under Swiss tax law. The taxpayer can rely on this when arranging tax affairs and the authorities are bound by their decision (unless the facts and circumstances change or there has been fraud or misrepresentation in the original discussions). In the UK discussions with HMRC may result in a view being expressed but HMRC will not be bound by this and it is merely an indication of how the issue may be viewed at a later date. Even if the view is confirmed in writing the taxpayer cannot rely on the opinion and has no certainty even though they sought assistance in good faith prior to entering into a transaction.

The second lesson to be learned is the general attitude of the tax authorities. In Switzerland the Federal and Cantonal tax authorities treat tax payers as customers and want to have constructive and helpful conversations, sometimes even suggesting alternative, more tax efficient options. In the UK HMRC tend to treat tax payers not as customers but rather as shoplifters who are trying to get away with

not paying tax. This sours relationships between the tax payers and HMRC and makes the stated aim of openness and real-time consultation much harder to achieve. **A general shift in attitude of HMRC would be very welcome. If HMRC were seen as helpful and approachable the perception of the UK regime would be improved substantially.**

In the past two or three years HMRC has invested in developing industry specific knowledge and this should be continued. The taxation of insurance companies, and to a lesser extent most other elements of the financial services industry, is vastly different to the way most other companies are taxed. The impact of regulation means that very often insurance companies cannot apply tax law as drafted and as a result HMRC needs to have a good understanding of the industry and its particular issues and quirks to be able to work effectively with taxpayers. Fiscal authorities throughout the world suffer from this issue and any authority which is able to demonstrate industry knowledge and understanding, along with the other customer focused suggestions in this section, would make the UK an attractive regime for the insurance industry.

c) Specific London Market tax changes

The comments above apply equally to all industries and are not in themselves going to increase or decrease the amount of tax paid by UK resident members of the London Market. The following three suggested amendments would impact the effective tax rates of market participants based in the UK.

i) Claims Equalisation Reserves (CER) or Catastrophe Reserves

As mentioned in section 2 above, the profitability of many of the participants in this market are subject to fluctuation as the underlying risk insured or reinsured are linked to catastrophes. In benign years the London Market can be very profitable but when catastrophes occur large losses are realised (in 2005 the global specialist risk market lost \$65bn as a result of Hurricanes Katrina, Rita and Wilma, in 2008 Hurricanes Gustav and Ike cost the market around \$17bn and the 9/11 attacks in 2001 on the World Trade Center cost the market over \$40bn).

The premiums charged for this type of catastrophe insurance are determined based on actuarial calculations of the quantum of likely claim and the expected frequency of such a loss. The premium is designed to meet a wide range of possible outcomes and is designed to build cash reserves over a number of years to enable the insurer to meet large catastrophe claims as and when they arise. On this basis it does not make sense to tax all of the profit in good years when in reality some of the profit will be used to support losses in the bad years. These “rainy day” reserves are called equalisation reserves (CER) or catastrophe reserves. Reserves are set up

on line by line basis for each class of catastrophe business and the calculation of the reserves reflect the peculiarities of each class of business.

For a number of years the company market element of the London Market has enjoyed a tax deduction for increases in CER in good years and have had losses restricted for tax purposes when the CER has released funds in loss making years. This type of smoothing of profits for tax purposes is available in many other jurisdictions. The amount of deduction is determined by the movement in the reserve reported in the insurers regulatory or FSA return.

The Lloyd's element of the London Market has historically not been able to smooth profits for tax purposes in this way as they have not prepared FSA returns and the CER is not included in the financial statements. In order to level the playing field between the two classes of participants in this market legislation has been enacted allowing members of Lloyd's to calculate a CER for tax purposes and to tax this accordingly. This reserve is not included in any of the various financial statements and is a reserve for tax purposes only. This law change has been welcomed by all aspects of the market.

One of the biggest issues facing the insurance market across Europe is the implementation of a new capital and regulatory regime known as Solvency II. Solvency II presents many challenges and opportunities which are not discussed in this paper, but one issue that is relevant to this market is the fact that post implementation in 2012, companies will no longer need to produce an FSA return. As a result the Company Market element of the London Market will no longer benefit from a tax deduction for CER and will lose the ability to smooth profits for tax purposes that they have enjoyed for many years. The rules allowing Lloyd's members to create CER for tax purposes could continue as this is not based on reserves included in the FSA return.

Our proposal is that the tax benefits of CERs should be allowed to continue after the implementation of Solvency II and that the rules allowing Lloyd's members to create the reserves should be extended to all of those writing the relevant classes of business. Insurance companies located across the EU who have benefited from these provisions in the past will not be able to benefit from these in the future unless legislation is changed in that particular member state. By extending the existing Lloyd's legislation the UK regime will become more attractive to companies located elsewhere.

The UK regime would allow companies operating in the UK to tax their profits in a way that is truly aligned to the reality of their

business. It is further recommended that the industry is consulted as to whether the level of provision allowed for certain classes of catastrophe business in the calculation of CER is sufficient and whether it reflects the realities of pricing these lines of business.

The cost of this extension is minimal. From 2009 all members of the London Market writing the relevant classes of business have been able to benefit from this treatment and therefore the proposal will not reduce the existing tax base merely stop the tax base from increasing. The likely increase is difficult to quantify simply as to do so would require the FSA returns for all members of the company market to be analysed. It could be assumed that the likely cost would be lower than that arising from the extension of the CER provisions to Lloyd's members, which case was estimated to be £15m in 2008/9 and £35m from 2009/10 onwards¹⁰, as the company market is approximately two thirds of the size of the Lloyd's market. This proposal will not impact the effective tax rate of the group overall as the effect of the CER is merely to split current and deferred tax rather than total tax. However it does impact the cash tax paid by those companies which benefit from the provisions.

The CER provisions will result in the impact of some of the "peaks and troughs" of corporation tax receipts in the UK from the London Market companies being reduced. It should also be noted that CER provisions do not offer a permanent deferral from tax for the company but rather a timing benefit. London Market companies and the UK economy could benefit from the smoothing of profits and tax receipts as a result.

ii) Controlled Foreign Companies (CFC) rules and intra-group reinsurance

Intra-group reinsurance is the process of one group company reinsuring another. It is important to understand that reinsurance is not one company passing on to another party the risks it underwrites, but rather an indemnity of the first party for any losses that they may incur (the contractual relationship between the insured and the insurer are not affected). The term intra-group reinsurance is a catch all term and used as such in this paper, it also applies where the original business of the group was reinsurance business rather than insurance business. The reinsurance of reinsurance is called retrocession.

The majority of entities operating in the London Market use intra-group reinsurance to manage their capital requirements and to support overseas subsidiaries through leveraging the strength of the group. Through centralising all of the risks written by one group in one company economies of scale can be achieved and the risk profile of a group can be

¹⁰ Table 1.2: Estimated Costs for Pre-Budget Report policy decisions and others announced since Budget 2008 – Facing global challenges: supporting people through difficult times, Pre-Budget Report (Nov 2008) produced by HM Treasury.

reduced through diversification of the types of risk or the geographical spread of risks written. Insurers and reinsurers participating in this market rely on ratings issued by rating agencies such as Standard & Poors and Fitch. In the past these agencies have preferred to see a centralisation of a group's risk in one entity when they award a group rating.

As discussed previously in this document London remains at the centre of the global large commercial and specialist risk market. Many of the global participants in this market have a presence in London as a significant proportion of the risks to be insured or reinsured are offered to the market by brokers located here. Whilst many groups have an operation in London, very few of them are parented here (approximately one third of the London Market is UK parented) or use the UK as the group's intra-group reinsurance hub. The main reason for this is tax.

The profits of the group's reinsurance hub would be subject to UK corporation tax if it was located in the UK and this would make the group uncompetitive from a return on capital/investment perspective and possibly from a premium pricing perspective as well. As a result most groups centralise their reinsurance vehicle in jurisdictions such as Bermuda although recently Switzerland and Ireland have also been used for this purpose.

Where groups utilise this offshore reinsurance structure it is almost impossible for the parent company of the group to be located in the UK. This is as a result of the UK's controlled foreign company (CFC) rules. The CFC rules require that the profits of a company located in certain jurisdictions (broadly those where the tax rate is less than 75 percent of the rate levied in the UK) be treated as if they arose in the offshore company's UK parent and taxed accordingly.

There are various exemptions from these rules but it is very difficult for a company operating in this market to fall within them. The main exemption is known as the exempt activities test and for an insurance or reinsurance company to fall within this exemption more than 50 percent of the company's business must be derived from third parties. Where the principle activity of the group reinsurance company is to centralise risks in order to gain the commercial benefits listed above, it is not possible to meet the requirements of this test.

We believe that changes could be made to the exempt activities test to make the UK an attractive location for the parent company of the group but that the UK will never be the first choice for the group reinsurance company unless the rate of tax was much lower than it is now (the London 100's recent survey would indicate that the rate would need to be between 15-17.5 percent at the most for this to happen). We also believe that the changes could be made in such a way as to boost the

economy through the repatriation of funds to the UK and that the changes should have little cost to the UK.

Our proposal is that the exempt activities test for insurance and reinsurance companies should be amended to require that either 25 percent of the company's business is derived from third parties or that a company is not considered to be a controlled company for UK tax purposes if the connected party business it writes relates to non UK risks.

The benefit to the insurance company would be to reduce the effective tax rate of the group as a whole whilst the UK could still tax the profits arising from UK risks. Additional requirements around repatriation of a certain percentage of profits from the offshore reinsurance vehicle could be added in order to qualify for the exemption and this would provide an injection of cash into the economy.

This would need to be considered in light of local regulation and capital requirements in the offshore territory. Were these changes to take place, the UK would be a very attractive jurisdiction to locate the parent company of a London Market group.

The treatment arising as a result of the proposed change regarding reinsurance of non UK risks could, under current legislation, already be available. One of the other exemptions to the CFC rules is known as the motive test. This allows a company to fall out of the CFC rules where the motivation behind the structure is not one of the avoidance of UK tax. In fact it is rumoured that one insurance company operating in the UK has structured itself in this way and is not attributing profit to the UK on the basis of the motive test. The issue is that mentioned at 3(b) on page 6 in that it is not possible to get certainty as to the application of this exemption. Writing this into legislation or guidance would give companies the certainty that they need and therefore plan their affairs in a way where the outcome is understood and could be relied upon.

This amendment, alongside the other changes brought into effect during 2009 in respect of the taxation of overseas dividends and the fact that the UK is rated very highly as an insurance jurisdiction, would make the UK one of the most attractive parent company locations in the world. This would allow the UK to be the home of this segment of the insurance industry once again and would mean that the strategic direction of this market would be determined in the UK.

The cost of implementing such a measure should be low. The majority of the larger participants in this market are parented offshore and arrange their affairs in such a way that there would be no attribution of overseas profits into the UK tax net. In addition most UK operating platforms of overseas

parented groups already reinsure part of their business written in the UK, including UK risks, to connected party reinsurance hubs. Little tax revenue would be lost as a result. The remaining UK-parented groups would most likely take advantage of the new rules and set up an offshore reinsurance vehicle.

It is very difficult to estimate the cost to the UK Exchequer of this proposal but we have attempted to make some high level assumptions:

- The three largest UK parented London Market participants in 2008 had a combined premium income of approximately £3.2bn. Assuming a combined ratio of 95 percent (ie 5 percent of premium received is profit) and that no additional tax planning is entered into, this would equate to a taxable profit in the UK of £158m or £44m in tax;
- If we assume that 10 percent of the premium relates to UK risk and that 75 percent of the remaining premium is reinsured to a connected party and therefore falls outside the UK tax net. Under our proposals the premium subject to tax in the UK would equal £1.03bn, profits under our assumptions would equal £51m and taxable receipts would total £14.5m;
- Three of the largest Bermudian parented groups which mainly operate in the London Market have combined premium income in 2008 of approximately £4.1bn. It would be reasonable to assume that the majority of the premium income of these companies is currently or could be originally earned in the UK but also that 75 percent of the premium income is reinsured to Bermuda. On the basis of the same assumptions as set out above this equates to UK taxable premium of £1.03bn, taxable profit of £51m and a tax charge of £14.5m;
- Under our proposed regime if the group were to become UK parented and reinsure non UK risks in the way described in the second bullet point above the revised taxable premium in the UK would equal £1.35bn, taxable profits would equal £67m and taxable receipts would total £19m;
- There are many more non UK parented groups than those parented here and the foreign owned groups tend to be bigger. As a result it might be reasonable to assume that the lost tax receipts from UK parented groups would be offset by new receipts from foreign-owned companies locating their head office and operations here; and
- We would expect the increased income tax and national insurance contributions arising from jobs created through overseas parented companies choosing to relocate the parent entity to the UK to exceed this amount.

Were profit repatriation requirements to be included in the new rule it is unlikely that this would give rise to taxable income in the UK as most dividends received are excluded from the charge to tax. This would however serve to inject cash into the UK economy and so indirectly taxation receipts may increase. There are recent precedents for profit repatriation requirements to be added to UK tax legislation. Until recently it was possible to defer tax arising on the profits of a controlled foreign company (the predecessor regime for the taxation of overseas investments to the CFC rules) where a certain amount of profits were distributed to the UK parent. In this case the requirement was for 90 percent of profits to be repatriated to the UK. The level of any required distribution must be considered in light of local regulatory or capital requirements in the offshore jurisdiction.

It should be noted that HM Treasury published a consultation document (*Proposals for controlled foreign companies (CFC) reform: discussion document*) in January 2010. At 2.13 of this document HM Treasury state that it is proposed for a reinsurance subsidiary to fall outside of the CFC regime where there is no erosion of the UK tax base and the company is holding the appropriate level of capital. We do not believe that this proposal goes far enough and would not benefit the London Market. This proposal would only allow non UK subsidiaries to reinsure to the connected party reinsurer rather than allow non UK risks written by a UK company to be reinsured. We believe that the proposal as currently drafted will not attract non UK parented groups to the UK in any great number.

iii) Branch profits exemption

The current tax rules impose UK tax on worldwide income of companies incorporated in the UK or otherwise deemed to be within the charge to UK tax. As a result profits and gains realised through overseas branches are subject to tax in the UK as well as subject to tax in the host country. To ensure that companies do not suffer double taxation on branch profits credit is given in the calculation of the UK tax for the foreign tax suffered on those profits. The credit is limited to the lower of the overseas tax suffered and the UK tax chargeable on those same profits.

The operation of the credit system means that the UK only receives tax revenue on overseas branch profits where the rate of tax in that host country is less than the rate of tax in force in the UK at that time. It is noted that it is the stated desire of one of the main UK opposition parties if successful at the next general election to reduce the UK top rate of corporation tax to 25 percent immediately following the election and that in the short to medium term it is intended to reduce this rate still further.

Even at 25 percent the UK would enjoy one of

the lowest rates of tax in Europe and the rate would be 10 percent lower than the rate of tax in the US. Were the UK rate to be reduced to 20 percent the only significant European nations with a lower tax rate would be Ireland and Cyprus. As a result the reality will be that very little tax revenue is derived by the UK from the taxation of branches.

Branches are very important in the development of group structures in the insurance and reinsurance industry, particularly when attempting to maximise the capital efficiency of a group. Within the EU an insurer or reinsurer located and regulated in one jurisdiction may operate freely and underwrite risks located in any other member state. This freedom is available as a result of the single European passport for financial services. Solvency II will make branches even more important in the make-up of European structures as groups try and maximise the use of their capital around their various operating jurisdictions.

Typically an insurance company in Europe will be regulated by the relevant authority in the country in which it is incorporated. The regulatory approval of that country will be deemed sufficient for all other countries in the EU and so, subject to obtaining the necessary licence to underwrite in other member states, the insurer need not seek any further regulatory approval. The insurer will have a branch in each of the other member states for which it holds a licence and the local regulator in each of those countries will allow the head office regulator to regulate the branch operations. Capital to support the underwriting activities of the company and its branches will be held in the head office location. There may be a notional allocation of capital to the branches but no capital need be physically held there. The structure described above is often described as a “hub and spoke” structure and would be typical for a Company Market participant. The peculiarities of the Lloyd’s model mean that business can be written without the need for branches or the need for separate licences in each state (Lloyd’s has a large number of licences which are available for all its members).

Our recommendation is that the UK should exempt branch income from the charge to UK tax. This change in legislation would make the UK an attractive jurisdiction to locate the company for both European parented companies who wish to use the hub and spoke approach and also for groups parented in the US or elsewhere in the world who were looking for a location to base their European locations. This would result in the capital used to support the company and its branches being located in the UK and the investment income derived from the capital would be subject to tax in the UK. We would expect jobs to be created in the UK as a result of

the head office company being located here and the FSA would become the lead regulator for the European insurance industry.

Through this proposal the UK could become the stepping stone for the rest of the world to enter the European insurance and reinsurance market. Many insurers and reinsurers based in the US already participate in the European market and the expectation is that in the medium term new global insurers will be developed in the emerging markets of the Middle East and China. Under the proposed change to the UK tax regime the UK would be more attractive than Switzerland, which does not tax branch profits but does not have access to the single European passport and possibly more attractive than Ireland which does have access to the passport but also taxes branch profits (although only at 12.5 percent and a credit against foreign tax suffered is allowed).

The cost of such a change in legislation should be small from the perspective of the insurance industry as the majority of the major European and world markets impose tax at rates higher than those likely to be levied in the UK. As a result it is unlikely for there to be a great deal of UK tax receipts arising from the profits of overseas branches. It should be noted that this change of law would not just impact the insurance and reinsurance industry but rather UK corporation tax payers as a whole and so the cost of such a measure should be considered across all industries in the UK. Any tax revenue lost from the London Market participating through branches in jurisdictions with a lower tax rate than the UK is likely to be exceeded by the tax revenue arising from the taxation of investment income arising from the underlying capital supporting the company and branch operations.

This proposal will not reduce the total tax paid by a company with branches on its own. If the UK does not tax the branch profits the local host country still will and probably at a higher rate than the UK would. As a result this suggested amendment needs to be considered in conjunction with other tax planning ideas identified and discussed above.

Perhaps the most obvious way for tax to be mitigated in a branch structure is for the branch to reinsure some of its business to a connected party reinsurance platform. For example it would be possible for the French branch of a UK company to reinsure some of the profits of that branch to an Irish reinsurance vehicle. The premium paid to the reinsurance company would be tax deductible in France thus reducing the amount of tax paid in France (at 33.33 percent) and would be taxable in Ireland at 12.5 percent. The overall effective tax rate for the group can be reduced through this type of planning and capital efficiencies can also be achieved. Without the changes to the CC rules considered at 4(c)(ii) above, it would not be possible

for a UK-parented group to take advantage of this structure. In order to make the UK attractive as both a parent company location and as the jurisdiction to locate the hub of a European branch structure, both changes would be required.

There is no simple way to make assumptions as to the cost of this proposal or the likely increase in taxes arising from the taxation of investment income in the UK or the additional payroll taxes likely to arise as a result of the expected increased employment that this measure could give rise to.

(d) Individuals' participation at Lloyd's

The capital supporting the underwriting activity of syndicates at Lloyd's was traditionally provided by individuals but since the mid 1990's, as a result of various issues faced by the market, the majority of capital is now provided by corporate members of Lloyd's. In fact it is not possible for a new member to join the market in non corporate form.

Individuals are still an important source of capital for the Lloyd's market and in the last twelve months there has been an increase in the number of enquiries from individuals located around the world about entering the market.

Many Lloyd's syndicates have produced a solid return on capital over the last few years and it is seen as an attractive and reasonably stable investment for many. The return is also in the main uncorrelated with the credit markets and therefore offers an opportunity for participants to diversify and therefore de-risk their investment portfolio.

For new individuals joining the market there are three formats that they can adopt: they can either participate via a company that they incorporate and own (known as a NameCo); participate via a Scottish Limited Partnership (SLP); or via a Limited Liability Partnership (LLP). All are considered to be corporate members. Individuals who participated in the Lloyd's market prior to 1993 can remain as individual participators or can convert to one of the three options listed above.

NameCo's are taxed in the same way as corporate members, ie they pay corporation tax on their profits at 28 percent. SLPs and LLPs are transparent for tax purposes and the partners are taxed as individuals on their share of the profits under the income tax regime. Individuals who underwrite through LLPs

and the remaining individual members are also subject to Class 4 National Insurance Contributions on their profits. Assuming that the individuals have other income that exceeds the 8 percent NIC rate band (currently £43,875) this results in an additional 1 percent tax charge on profits.

The underwriting profits and the income arising from investment of the premiums received are taxed on a declaration basis (i.e. when the underwriting year is declared, the 2009 underwriting year closes on 31 December 2011 and is declared in April 2012). The income arising from the investment of assets underlying the underwriting business is taxed on a calendar year basis even though it may not be distributed or available to the member until the year has been declared. As a result some deferral of tax is possible, but not complete deferral.

NameCo's, LLPs and SLPs are corporate members and therefore should be able to benefit from the Claims Equalisation Reserve provisions discussed above. Individual members have an equivalent reserve called the Special Reserve Fund (SRF).

Our recommendation is that the National Insurance position of the various types of vehicle is equalised. Individuals and members of LLPs should not be subject to Class 4 contributions on their profits arising from participations in Lloyd's. In addition we believe that all income arising from the participation at Lloyd's should be deferred until the year is declared. This would result in an investment that would share many of the characteristics of the products offered by the asset management industry and allow a "gross roll up" style product where all income was only taxed when received by the investor. This would put investment at Lloyd's on an equal footing with these other products. We do not believe that the cost of this measure would be great. The lost NIC revenue would likely be minimal but it is not possible to quantify. There would be no tax lost by allowing all income to be deferred, it would merely be a timing issue. We would also expect more investment to come into Lloyd's from around the world on this basis and this would give rise to new tax revenues (all individuals, no matter where they are resident or through what form they are investing are subject to tax in the UK on the profits made through participations at Lloyd's).

4. Conclusions

The London Market is one of a small number of industries that has come through the recent credit crunch relatively unscathed. It is a well regulated, well capitalised and often very profitable industry that takes a cautious approach to investments, seeks to manage risk over the long term and provides for a rainy day. The global large commercial and specialist risk market has its origins in the UK and the UK still has a preeminent position within the industry. The climate is right now for the UK to once again stamp its authority on this market and take advantage of the issues facing other jurisdictions.

The UK is already seen as one of the most attractive locations by members of the London Market and in particular the reputation of the regulator, access to business and capital and the availability of high quality labour resources are cited as UK strengths.

The one thing that keeps groups from locating themselves here is the tax regime. In this paper we have suggested a small number of simple and we believe cost effective measures that would make the UK tax regime very attractive to participants in the market:

- The change in the nature of the tax regime and the underlying attitude of HMRC would demonstrate the UK's willingness to want to make the UK tax regime more business friendly, this small change could have a big impact on the perception of the UK as a jurisdiction;

- The retention of a tax deduction for CER after the introduction of Solvency II would allow companies operating in this feast or famine market to arrange their tax affairs in line with the way they operate their business, by being prudent and putting something aside for when times get tough;

- The changes to the CFC rules would allow international groups to be parented in the UK whilst keeping effective tax rates low but would also allow the UK tax base to be maintained. This provision would also give the UK control over the strategic direction of this industry; and

- The branch profits exemption would see the UK as one of the main locations to base a European hub, bringing investment income into the UK and formalising a position that would exist in any case were UK corporate tax rates to drop.

Our expectation is that these measures will taken together will not lead to any significant change in UK corporation tax receipts, may give rise to increased receipts from income tax and national insurance contributions but also bring along with them less quantifiable benefits. The estimated costs and benefits included in this paper are draft and the proposed changes kept at a high level. The London 100, the members of the organisation's tax working party and the members as a whole would be very happy to work with all political parties further to explore these ideas and provide more detail to the design.

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