TAXREP 20/00

INSURANCE RESERVES

Memorandum submitted in May 2000 to the Revenue by the Tax Faculty of the Institute of Chartered Accountants in England and Wales in response to a consultation paper issued in April 2000 and on Clause 106, Finance Bill 2000

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GENERAL INSURANCE TECHNICAL RESERVES

INTRODUCTION

1. We welcome the opportunity to comment on the issues in the consultative document: 'General Insurance Reserves Consultation on Proposals for Regulations' issued in April 2000 by the Revenue. Our comments refer to that paper (the questions in which we reproduce below in arial typeface) and clause 106 of the Finance Bill 2000. Representations on clause 106 of the Finance Bill that we have already submitted to the Chancellor are reproduced in the Annex.

ISSUES FOR CONSULTATION

Question 1

The Government's view is that it is appropriate to use a rate linked to the rate of interest on medium / long gilts to calculate the discounted value of liabilities. Are there alternatives which might be equally, or more, appropriate?

2. As all classes of business are to be subject to the charge, a single rate will always be unfair to many. Fairness can only be achieved uniformly where taxpayers use their own experience, as will be adopted in determining the final claims settlement curve. Logically there should be an opportunity for companies to elect to use an actual rate of return. However we recognise that this may be impracticable given the complexity of regulations, and the difficulty of the resulting calculation, that would be required.

3. We do however believe that it would be more suitable to perform the calculations separately for each class of business. The FSA categories may be used to distinguish between classes of business. Moreover it may be appropriate to omit from the calculations those classes of business which have no significant long term element.

4. The use of a sterling rate as the sole measure of investment return where the investments are intended to broadly match currency exposures (regulation 27 Insurance Companies Regulations 1994) is a serious deficiency and even more so where the taxpayer has made a local currency election or is a controlled foreign company computing chargeable profits in a currency other than sterling. We propose that companies should be able to elect, on a class by class basis, to use a local currency government security rate.

5. The impact of reserve volatility should also be taken into account and we would expect any discount rate used to be adjusted for risk. The level of risk will vary across types of business. We therefore feel it would be appropriate to incorporate into the discount rate a risk margin, which should be defined according to class of business.

6. The use of an interest rate referenced to the return prevailing at the end of the accident year for all clause 106 computations for that accident year, irrespective of the actual investment return on the assets held, is flawed. It would be more appropriate to update the discount calculations each year by the rate prevailing at the end of that year. For example, if the

prevailing rate in 2001 is 6%, and in 2002 it falls to 5%, then the 2000 reserves at the end of 2002 will be discounted back to their 31 December 2000 value by dividing by 1.06 and then by 1.05. This method would have the advantage of creating a rolling average rate, which will be closer to the companies' actual rates of return.

Question 2

Does the Government's proposal for a 10 year cut-off for the discounting of very long tail business strike the right balance between simplicity and fairness?

7. Yes.

Question 3

The Government proposes that the new rules should not require tax adjustments where a technical provision is within plus or minus 5% of the discounted value of insurance liabilities to which it relates. What arguments might favour either a narrower or a wider margin of error?

8. The margin attempts to mitigate the effect of a measure which imposes a tax base, which if followed into the commercial accounts would in most instances be unlawful. We believe most insurers would welcome an increase in the margin to, say, 10%, to reduce the differences between the accounts and tax base.

9. In the case where a company has under-estimated the level of reserves, "negative interest" will arise. To the extent that this interest cannot be offset against previously taxed interest charges (see response to Question 5 below), we believe that it is inappropriate to apply a margin in its calculation.

Question 4

In calculating tax adjustments required, if a technical provision exceeds the discounted value of the liabilities to which it relates, the Government proposes to apply a rate of interest linked to that set under Section 87A Taxes Management Act 1970 for unpaid corporation tax. Do respondents agree that the use of that rate, on the basis set out in the explanation of the interest calculation, produces results which achieve the broad parity of tax treatment that the Government is seeking between insurers and others?

10. We understand why, given the apparent purpose of the Finance Bill proposals, the use of the Section 87A TMA 1970 rate of interest, net of tax, is suggested. However, this rate exceeds the rate required to fairly compensate the Government. There is an element of "penalty", since the Section 87A rate is set at two and a half percentage points above the base rate. Insurers would not accept that they are being taxed with "broad parity" compared to others. A fairer approach would be to apply the underlying base rate plus one percentage point, which is consistent with the rate applicable to underpayments of quarterly instalments.

Question 5

The Government's proposals include making a provision for cases where technical provisions are set at too low a level as well as for cases where provisions are higher than a discounted best estimate of liabilities. Does the even-handed approach proposed lead to any practical difficulties?

11. The approach is not even-handed in that it does not allow deficits to be set off against excess of earlier years. If the Government will receive the benefit of hindsight, surely an even-handed approach would allow the industry to do the same.

12. If the "negative interest" cannot be carried back, there is potential that the insurer will not receive the benefit of the full discounting unwind at the ultimate end of an underwriting year's run-off of its claims.

13. In order to avoid this lack of even-handedness, we suggest that in each year where additional income is attributed to a company under clause 106, the amounts attributed should be recorded on the CTSA return as a "credit". This "credit" would then be carried forward, and when "negative interest" arose in later accounting periods it would be offset against this "credit" and an immediate repayment, with interest, obtained.

Question 6

The Government proposes that in applying these rules to members of Lloyd's:

- adjustments will be made by members rather than in the computation of syndicate profits
- members will be excluded from the new rules for syndicate business where the extent of their participation is 4% or less
- a matrix approach will be used to identify how much of a syndicate's claims in any year are to be allocated to the member for the purpose of calculating the discounted valuation of liabilities.

Are any adjustments necessary to these principles to ensure that the Government's aims are achieved in relation to Lloyd's members?

14. It seems logical for the adjustments to be made at member rather than syndicate level given the proposed "de minimis" rules and the adjustments required to convert from syndicate to member underwriting years.

15. The paper ignores the issue as to how participation is to be defined; for example, will capacity owned through a MAPA be included with capacity owned as a bespoke name in arriving at the "participation" of a name.

16. The reasoning behind the proposed matrix approach seems fair but applying this approach in practice will impose a heavy compliance burden on names which change the level of syndicate capacity held each underwriting year. It should be noted that two sets of matrices are required, one to allocate claims paid by the syndicate for an underwriting year to the member's underwriting years, and one to allocate the reinsurance to close (RITC) to the

member's underwriting years. These detailed computations must be carried out by a Lloyd's member for each syndicate in which it has more than 4% of the capacity before the "discount calculation" can be carried out.

17. The paper incorrectly assumes that a Lloyd's year of account is the same as an accident year. We suggest that the rules are applied on an underwriting year basis.

OTHER ISSUES

Unearned Premium Reserve (UPR)

18. We believe the consultative document is incorrect in suggesting that the UPR should be discounted, even when it extends beyond one year. The consultative document justifies the discounting of a UPR extending for more than a year, since the company will have had the benefit of investment income on the premium from the date of receipt. However, the whole of such investment income will have been reflected in the financial statements of the company and brought into charge to tax. The only deferral will be of profit, not income, and any profit deferred will be brought into charge as the premium is earned for accounts purposes.

19. The consultative document makes no reference to how the discounting calculation should be adjusted when premium is received over time.

20. It seems inequitable to discount the UPR for tax purposes and also defer relief for acquisition expenses.

Run-off Business

21. When an insurance business is in run-off, generally a scheme of arrangement is agreed with the liquidator whereby liabilities are paid at less than their commercial value. The result of these arrangements can be a large credit to the profit and loss statement. However, under current tax law (section 94, ICTA 1988), these movements in the profit and loss account due to the reduction in the value of the reserves under the scheme of arrangement are not subject to tax. It should be made clear that the discounting calculation should not penalise the run-off insurer because of the re-valued (lower) reserve number determined under the scheme of arrangement. The regulations should deal specifically with schemes of arrangement.

Controlled foreign companies (CFCs)

22. The rules will further exacerbate the problem already faced by CFCs trying to follow an acceptable distribution policy. The interest attributed under clause 106 will presumably serve to increase chargeable profits of the company in question. However, since the company's distributable profits will not likewise be increased by the clause 106 interest, the company may be put in a position where its distributable profits cannot meet 90% of its chargeable profits, and it is therefore unable to make an acceptable distribution.

23. We suggest that this problem may be countered by excluding any clause 106 charge from chargeable profits in the acceptable distribution test, the UK parent company instead

becoming liable for the additional tax under clause 106, whilst allowing the CFC to make acceptable distributions.

Basis of calculations

24. It is unclear exactly how the proposed calculations will apply in the case of funded business. It seems logical that insurers should have a right of election to apply the rules on an underwriting year basis or an accident year basis, depending on the form of their underlying information, since it would impose a significant and unnecessary burden to require accident year calculations that account on an underwriting year basis.

25. Clarification is required as to how an election to partially disclaim reserves will operate, and how the interest charge will be applied in such cases, before the regulations are published. In particular, to ensure even-handedness between taxpayers and the Revenue, who are taking the benefit of hindsight, taxpayers should be given a fair degree of flexibility regarding the time limit within which disclaimers may be made and withdrawn. The provisions in paragraph 4, Schedule 24, ICTA 1988 would then need to be amended to extend the time period in relation to CFCs.

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ANNEX

COMMENTS ON CLAUSE 106, FINANCE BILL 2000 SUBMITTED TO THE CHANCELLOR ON 12 MAY 2000 IN TAXREP 17/00

177 By itself this clause says very little other than giving the Board of Inland Revenue power to draw up regulations in order to introduce a new regime for allowing/taxing insurance reserves set aside to meet future claims. However, it raises two major points. First, why does the Revenue want to enforce discounting to such a degree on a major UK industry? In recent years there has been a growing acceptance that accounts prepared in accordance with generally accepted accounting practice should form the basis of the calculation of taxable profits. We think it a retrograde step to deport from such accounting principles except in exceptional circumstances. If accounting requires discounting we believe it right that tax should also require discounting. Conversely where accounting adopts current values without any discount we can see no reason why the tax system should not follow suit.

178 Secondly, is the level of uncertainty these proposals raise an appropriate way to treat an important UK industry? We believe that the perception of over-reserving is not substantiated and as the barriers in the EU in this field are coming down, the UK is being placed in an overly restrictive and damaging position in relation to our EU partners.

179 At the same time as the Finance Bill was released, the Revenue issued a consultative document as a pre-cursor to the regulations, setting out how it intended the new legislation to work and seeking feedback on a number of prescribed parameters, limits and rates to be applied. Again, there is little concrete to comment on other than to say that most of the additional burden of reporting the information required for the legislation to work will fall on syndicate managing agents and their advisors although this is unlikely to be too onerous. There is little detail on how these new rules will actually work in practice.

180 One of the parameters subject to consultation is a de minimis limit of syndicate capacity below which a member or Nameco will be exempted from the legislation. Clarification is needed as to whether this de minimis limit will apply to a MAPA as a single entity or whether it will be possible to ‘look through’ the MAPA to establish individual members’ shares of the syndicate capacity within the MAPA as a whole. If the latter, it is anticipated that this will take the vast majority of individual Names and Namecos out of the scope of these regulations which will then only affect the dedicated and integrated Lloyd’s vehicles and larger group Namecos.