

PARTIAL REGULATORY IMPACT ASSESSMENT (RIA)

1. Title of proposal

The proposals affect the tax treatment of general insurers' reserves. Current legislation is at section 107 Finance Act ("FA") 2000 with Regulations at SI 2001/1757.

2. Purpose and intended effect of

The policy objective is to ensure that the tax rules dealing with general insurers' reserves are proportionate to the tax risk that they seek to address. In particular, the government aims to reduce the cost to industry of complying with the current tax rules and to eliminate the tax lost to the Exchequer through the use of an election within the rules.

Background

All general insurers¹ make what in technical accounting terms are provisions (or what are often still referred to as "reserves") for claims against insurance policies that they will have to pay out in future years. Provisions for future claims are by their nature estimated. The amount of the provision is determined in accordance with accounting standards², which focus on making sure that the provision is large enough to pay all claims that can reasonably be foreseen.

A provision that is larger than the amount needed to pay claims defers recognition of profit, and therefore payment of tax. Section 107 FA 2000 was introduced to limit any tax advantage if a general insurer's provisions are over-estimated. Extensive Regulations require general insurers to compare the original provision with the later cost of settling claims and make a tax adjustment if there is a difference. The tax adjustment is in the Exchequer's favour if the original provision was too large and in the general insurer's favour if the original provision was too small.

The primary legislation includes an election ("the disclaimer election") the intention of which was to provide general insurers with the flexibility to disclaim a small proportion of their reserves to mitigate the effect of the tax adjustments that would otherwise arise. The disclaimer election has also been used to accelerate the use of tax losses in groups of companies, which causes a significant loss of tax.

Rationale for government intervention

The current tax rules dealing with general insurers' provisions are complex, lengthy and require continual maintenance. The operation of them therefore is at considerable cost to general insurers and especially at Lloyd's where the calculations are particularly difficult. Unless there is a change to the current rules, the way that they operate is likely to mean an increase in this cost until at least 2010 after which it would remain level. The frequent need for maintenance represents an additional burden for both general insurers and government in consultation over the technical detail and in implementation.

Industry representatives have assured HMRC that provisions for claims are set solely in accordance with a reasonable standard of prudence and not with a view to the tax advantage that might result. Analysis of trends across the general insurance sector supports this assurance. That is not to say that no provision is excessive, but it does suggest that the current rules may be disproportionately complex for the tax risk that they seek to address, and that they merit a thorough review.

¹ general insurers for this RIA includes general insurance companies, firms carrying on general insurance business which operate in the UK through a branch, controlled foreign companies that carry on general insurance business, and members of Lloyd's

² paragraph 43 Schedule 9A Companies Act 1985

In addition, the use of the disclaimer election other than for its intended purpose causes a significant loss of tax. The tax lost to date is estimated to be £740M. Of this around £640M has been lost through the accelerated use of tax losses, and from the use of losses that would otherwise never have been tax effective. £100M has been lost as a result of artificially created taxpayer-favour adjustments, but will not recur because of changes made to the Regulations in 2003. If there is no government action, tax will continue to be lost.

3. Consultation

Within government

There has been extensive consultation with operational tax specialists in HM Revenue & Customs and with HM Treasury. The options discussed with industry were developed through this process and frequent discussions have been held to update progress and to obtain feedback. There is no impact on other government departments.

Public consultation

There has also been extensive informal consultation with representatives of the insurance sector including representative bodies – the Association of British Insurers (“ABI”) and the International Underwriting Association (“IUA”) – Lloyd’s, insurance companies and their accountants, and other interested parties including the Financial Services Authority (“FSA”) and actuaries.

This process began in January 2006 at which time the government’s focus was on the extent to which the disclaimer election was undermining the effectiveness of the rules. The industry response was clear and consistent: the disclaimer election was essential to maintaining the fairness of the rules, but there was anyway a case for a more wide-ranging review.

At Budget 2006 the government announced further consultation to identify an appropriate way forward. A working group of HMRC and insurance sector representatives (the “Working Group”) met several times throughout summer 2006 to consider options.

There have been two HMRC / industry joint presentations to publicise the consultation, to outline progress and to encourage input. The first of these was organised by industry on 16 June 2006 and the second by HMRC, the Association of British Insurers, Lloyd’s and the International Underwriting Association on 13 October 2006.

As part of the review work HMRC also had meetings and exchanges with tax specialists from several other countries, including France, Spain, Germany, Ireland, Australia, USA and Canada.

4. Options discussed during consultation

No change

The consultation was on the presumption that any proposals would involve the repeal of the disclaimer election because of the tax lost through its use. No change would not achieve this aim and would not reduce the compliance cost to the insurance sector.

Repeal of the disclaimer election within the context of an overhaul of the current rules

This would stem the tax lost through use of the disclaimer election. The Working Group identified several improvements and simplifications that could be made to the current rules and which would be welcomed by the insurance sector. These though, and the repeal of the disclaimer election, would represent only a minor reduction in the cost of complying with the rules, and industry believe that those rules would then be overly harsh and operate unfairly.

During the Working Group meetings, general insurers explained that regulatory rules influence their group structure and that the disclaimer election affords them access to group relief rules³ in the same way as other companies, albeit as an unintended impact of the legislation. They asked that, as an alternative to repealing the disclaimer election, the government consider restricting the effect or extent of it.

HMRC were unable to identify a restriction that would achieve the government's key aims to stem the tax loss through use of the disclaimer election and reduce the cost of complying with the tax rules in this area. An arbitrary restriction, perhaps related to the amount of the provision, was rejected because it would still leave the disclaimer election functioning, albeit in a reduced way, to address the group relief issue rather than for the purpose for which it was intended. More sophisticated restrictions – including consideration of a change to the group relief rules – were rejected as likely to add to the already complex legislation in the affected areas. And restricting the disclaimer election would not eliminate the tax loss, unless the restriction was so tight that making a disclaimer election would have no practical effect.

General insurers remain of the view that the disclaimer election is essential to maintaining the fairness of the current rules on reserves for future claims. Their view is that the suggested improvements and simplifications would not adequately balance the impact of repeal of the disclaimer election and that, if the disclaimer election is repealed, the rest of the rules should also be repealed.

This option – repealing the disclaimer election and overhauling the rest of the rules – would therefore be unpopular with, and strongly resisted by, general insurers.

Repeal of the current rules and replacement with a new regime

This option would result in repeal of the disclaimer election and would therefore stem the loss of tax from the use of it.

The Working Group was however unable to identify (elements of) regimes elsewhere in the world, or to design a new set of rules that were attractive to either government or to the insurance sector.

In particular, nothing was identified as improving on the current rules, at materially lower cost to the general insurers. For example, almost all required an annual test to be applied by general insurers to their provisions, which the Working Group was not convinced would represent a material reduction in the cost of complying with the tax rules in this area. This was lent additional weight at meetings and in exchanges between HMRC and tax specialists from several other countries who identified similar levels of dissatisfaction with the complexity and effectiveness of their own rules as had been expressed with the UK rules.

The Working Group was also concerned that any new regime might be overtaken in fairly short time by the changes expected from Phase II of the review of International Financial Reporting Standard 4. Any benefit afforded by a new system might therefore be short-lived and outweighed by the cost of implementing it.

There was no enthusiasm for this option.

Repeal of the current rules without replacement

This too would stem the tax lost through use of the disclaimer election. It would also represent for the insurance sector a significant reduction in the overall cost of complying with the tax rules.

There are however risks with this approach. The government would be vulnerable to a loss of tax if provisions were over-stated and its only redress would be to challenge the amount of the provision by formal tax enquiry in particular cases, as was the case before the introduction of

³ "Group relief" is the scheme under which a tax loss made by one company in a group can be surrendered by it and claimed by another: but the loss must be the loss of the same year, and must not include any losses that have been carried forward to the year.

section 107 FA 2000. Those tax enquiries proved costly for both sides and were generally unproductive. They relied for resolution on interpretation of compliance with the accounting standard, which provides an effective lower limit for provisions, but is not designed and is not sufficiently detailed to determine in most cases whether a provision was excessive.

Phase II of International Financial Reporting Standard 4 is expected to be implemented around 2010. This might produce an accounting standard of sufficient robustness to limit the tax risk from excessive provisions without the necessity for further tax rules, but this is some way off and the detail is by no means certain.

This option – repeal of the current rules without replacement – remains industry's preferred approach, although the Working Group acknowledged that it was not without risks. Discussions produced a further option which could provide both the benefits of repeal of the current rules and a measure of protection for the Exchequer against overstatement of provisions.

Repeal of the current rules and replacement with a “revenue protection measure”

A “revenue protection measure” would take the form of a legislative standard setting out the maximum acceptable provision for tax purposes thereby providing the clear ceiling that it is not the accounting standard's function to perform. It could be designed so as to impose no annual obligation on general insurers, yet enable HMRC to counter effectively exceptional cases of overstatement of provisions.

The provision calculated in accordance with accounting standards would normally be accepted for tax purposes and the vast majority of general insurers would not have to apply any other test. In exceptional cases, where the standard was breached there would be a tax adjustment.

Possibilities for operation of a revenue protection measure include

- ⇒ the general insurer would make an adjustment in its tax return if it breached the standard.
- ⇒ the general insurer would submit with its tax return an explanation for breaching the standard, if it believed that it had done so. There would be no automatic adjustment to the tax return. HMRC would enquire into the tax return if not satisfied with the explanation or if there was no explanation but it appeared that the standard had been breached.
- ⇒ no action by the general insurer. HMRC would identify exceptional cases where a general insurer had, or may have, breached the standard. In cases where significant amounts of tax were at risk an enquiry into the tax return would follow to seek an explanation.

All of these possibilities involve the repeal of the current rules and the significant reduction in the cost of complying with the tax rules that is inherent in repeal.

In the first possibility, the current annual obligation would be replaced with a new annual obligation requiring general insurers to test their provisions against an objective standard. This would affect the whole sector, but probably at less cost than that imposed by the current rules. Such a system might not be dissimilar to the current tax rules dealing with general insurers' reserves and is not favoured by HMRC or industry because it could prove just as inflexible as the current rules.

The second and third possibilities connote an element of judgment and discussion – most likely, if discussion was required, through a tax enquiry. The reduction in the cost of complying with the tax rules across the sector from repeal of the current rules would be replaced by a cost only on those general insurers that breached, or may have breached the standard and into whose tax return HMRC enquired. Such enquiries would be expected to be the exception, not the norm.

Central to the success of a revenue protection measure is the mechanism to resolve disputes about whether or not it has been breached, and, if so, to what extent. The absence in tax enquiries before 2000 of actuarial assistance in a highly specialised and technical area made disputes difficult to resolve and the whole process unsatisfactory for both parties. Actuaries are the experts in the field of estimating liabilities and one option therefore would be to seek the advice

of an independent actuary in cases of continuing dispute. If an independent actuarial report were required to resolve a dispute, the cost of obtaining it would fall on the general insurer. This would represent a further potentially significant cost to the particular insurer and is not a step that HMRC would take lightly. It is hoped though that the facility to require the production of such a report, allied with a right of appeal against the requirement, would operate to encourage resolution before this point was reached.

Referral to an independent actuary would not be an alternative to the appeals Commissioners who would still determine appeals in cases where HMRC and the taxpayer could not reach agreement. Any independent actuarial report obtained during the tax enquiry would be available to assist the Commissioners' deliberations.

This approach – a standard setting out the maximum acceptable provision for tax purposes, supported by a power to require production of an independent actuarial report with an established appeals process – would, to some degree, mirror the FSA's approach⁴ to the investigative process that supports their regulation of general insurance business.

To enable HMRC to risk-assess general insurers' tax returns, a new information requirement might also form part of the second and third possibilities. This would probably take the form of a breakdown of the provision, which, for UK regulated general insurers, would be satisfied by production of a copy of three or four pages from the regulatory return. For non-UK regulated general insurers, it might require details to be extracted from accounting records.

This option – repeal of the current rules and replacement with a "revenue protection measure" – has emerged as the most likely way forward, with the third possibility for how such a standard might operate as the industry's preference. Consultation with industry continues on the precise wording of a revenue protection measure and how it would operate; the form of an information requirement, if it is necessary; and transitional arrangements, if required.

All of the options for change will have effect on the date that Royal Assent is given to Finance Bill 2007, such that

- any existing rules which are repealed will not apply to periods of account ending on / after the date that Royal Assent is given to Finance Bill 2007
- any new rules which are introduced will apply to periods of account ending on / after the date that Royal Assent is given to Finance Bill 2007.

As almost all, if not all, general insurers have periods of account end on 31 December, where this is so, the practical effect of the proposed change will be that

- the existing tax rules will not apply to periods of account beginning on / after 1 January 2007
- the new tax rules will apply to periods of account beginning on / after 1 January 2007, that is periods ending 31 December 2007.

The periods of account affected by any transitional arrangements will depend on the precise scope of those arrangements, which have yet to be finalised.

5. Costs and benefits

Sectors and groups affected

Any change would only affect the general insurance sector. Those affected will normally be large businesses, or sophisticated small / medium businesses. There will be no race, Northern Ireland or other equality issues.

⁴ Parts IX and XI Financial Services and Markets Act 2000

Benefits

Repeal of the disclaimer election – inherent in all of the options except ‘no change’ – for periods of account ending after 31 December 2006 would increase Exchequer yield by £640M over the next 7 years as follows:

<u>2007-08</u>	<u>2008-9</u>	<u>2009-10</u>	<u>2010-11</u>	<u>2011-12</u>	<u>2012-13</u>	<u>2013-14</u>
£0	£130M	£150M	£130M	£100M	£80M	£50M

There would be no yield in 2007-08 because of the way the disclaimer operates to reduce profits of the general insurer in the year following the year in which the disclaimer is made.

Repeal of the rest of the rules would also increase Exchequer yield in the short term, but much more modestly, and the effect over time should be Exchequer neutral.

The requirements of the current tax rules impose a considerable cost to general insurers and especially at Lloyd's. The ‘no change’ option would have no effect on this, and repealing the disclaimer election and overhauling the current rules would have only an insignificant impact on this cost.

The other options consulted on involve repealing all of the current tax rules. Repeal would represent a significant cost reduction for the insurance sector. It would also represent a saving for HMRC in not having to check calculations made under the rules.

Costs

Potential costs will depend on the option for change that is finally selected.

Fuller details of compliance benefits and costs will be included in the Full Regulatory Impact Assessment to be published at or around Budget 2007.

6. Small Firms Impact Test

The only small firms potentially affected by this measure are Lloyd's members.

The current rules are framed in such a way as to exclude all, or practically all of the small businesses operating at Lloyd's. Preliminary discussions with Lloyd's on the impact of a revenue protection measure are positive. Lloyd's are represented on the Working Group and will continue to be consulted about the impact on all of its members. Any Lloyd's members affected already operate in a sophisticated business sector and have access at Lloyd's or through HMRC to any support they require.

As with larger firms, for all affected small firms, repeal of the current rules would bring a significant compliance cost reduction and, as long as their provisions were not excessive, there would be no new cost if a revenue protection measure were introduced.

7. Competition assessment

On latest available figures, general insurance business is carried on in the UK by 434 UK incorporated general insurance companies and 129 branches of insurance companies incorporated elsewhere (68 within the European Economic Area, 61 outside)⁵.

In addition there are 62 syndicates at Lloyd's containing 2199 Lloyd's members (1483 individuals, 471 small companies ('Namecos' and 'Group Conversions' run by former individual members), 132 Scottish Limited Partnerships (SLPs, also run by former individual members) and 113 large companies (often members of large groups)). Of these, the current tax rules affect UK incorporated companies, branches of foreign insurers and Lloyd's members with less than 4% of

⁵ according to the FSA's Annual Report 2006

the business written by a syndicate. In practice this excludes all, or practically all Lloyd's members from the current rules, with the exception of the 113 large company members.

The extent to which any or all of these firms would be affected by changes to the rules will depend on the precise scope of those changes. It is not expected though that any change would have a substantially different effect from firm to firm. For members of Lloyd's excluded from the current rules by the 4% limit, any new rules that were introduced could represent for them a new compliance cost depending on the precise scope of those rules – which is yet to be decided. As with all other firms in this sector however, any compliance costs from the emerging likely way forward will fall only on those general insurers that breached, or may have breached the standard under discussion, and into whose tax return HMRC enquired. Breaches of the standard, and therefore tax enquiries, are expected to be the exception, not the norm, and tax enquiries will only be made where there are significant amounts of tax at risk. It is unlikely therefore that the emerging preferred option would have any effect for the smaller businesses in the sector.

Such a change, if it were to happen, would not be expected to have any effect on the competitiveness of Lloyd's members within the general insurance sector – since business at Lloyd's is conducted at syndicate, not member level – nor would it be expected to have an effect on competition within the sector more generally. No particular businesses would be penalised by any changes under consideration and the effect of change is likely to be in proportion to the size of the individual business' reserves, which will be in proportion to their market share. All businesses affected by the current tax rules or potentially affected by a replacement measure operate in a sophisticated business sector. The sector is highly driven to find new products and new ways of marketing products and this measure will have no effect on this.

The complexity and effect of the current tax rules dealing with general insurance reserves are sometimes cited as counting against the UK as a territory for new insurance start-ups. As all options except the 'no change' option involve repealing all of those rules, this may increase competition in the UK general insurance market.

8. Enforcement, sanctions and monitoring

The '**no change**' option would not require a change in the present arrangements for enforcement, sanctions and monitoring.

The extensive rules set out how calculations must be done and how the tax computation is affected by the result of them. Cases of non-compliance with the rules would be dealt with using the normal enquiry powers available to HMRC compliance inspectors. Calculations done under the current rules are reviewed for accuracy and if necessary a tax enquiry is made. Sanctions in the case of errors, or non-compliance, follow the normal rules for tax enquiries.

Repealing the election within the context of an overhaul of the current rules is unlikely to result in any change to the present arrangements for enforcement, sanctions and monitoring. The tenor of the rules would be unaffected by the improvements and simplifications considered by the Working Group.

The enforcement, sanctions and monitoring necessary following **repeal of the current rules and replacement with a new regime** would depend on the detail of the replacement regime. There is no enthusiasm within industry or HMRC for a replacement regime and no consideration has therefore been given to these issues for this option.

The enforcement, sanctions and monitoring necessary following **repeal of the current rules and replacement with a "revenue protection measure"** would depend on the detail of the revenue protection measure and how it operates. There are three possibilities outlined above for how it might operate, which are under discussion with industry.

If general insurers were required to make **an adjustment in the tax return** where the standard is breached, the enforcement, sanctions and monitoring provisions would be similar to those already in existence. HMRC compliance inspectors would review calculations for accuracy and if

necessary make a tax enquiry. Sanctions in the case of errors, or non-compliance, would follow the normal rules for tax enquiries.

If general insurers submitted with the tax return an **explanation for breaching the standard**, where it believed that it had done so, HMRC would assess this explanation and might undertake a tax enquiry if not satisfied or, in the case where there was no explanation, it appeared that the standard had been breached. Sanctions in the case of errors, or non-compliance, would follow the normal rules for tax enquiries. The same applies if assessment of whether the standard has been breached were left entirely to HMRC with **no action by the general insurer**.

In both cases, monitoring would be through HMRC risk-assessment of tax returns and the information submitted with them. Given that our analysis of industry trends and assurances from industry suggest that provisions are not excessive when viewed across the general insurance sector, we would expect tax enquiries only in exceptional cases where there is thought to be significant tax at risk.

The process to resolve tax enquiries is central to the enforcement of any revenue protection measure. The options identified so far include following the normal rules for tax enquiries, which lead in the end to referral to the appeals Commissioners, and interposing a new power for HMRC to require the insurer to produce an independent actuarial report.

If such a power were introduced it would be subject to the normal appeals procedure that applies to notice to produce documents etc⁶. Such a power, if introduced, would be used to assist only in high-risk cases where disputes in this highly technical area could not be resolved between HMRC and the general insurer. It is recognised that such reports are expensive to produce and they would not be called for routinely.

The absence of actuarial assistance was the cause of difficulties with resolving tax enquiries into general insurers' provision before the current rules were introduced in 2000. A return to this situation would be unwelcome for HMRC and general insurers, hence consideration of the introduction of a power enabling HMRC to require the insurer to produce an independent actuarial report.

Referral to an independent actuary would not be an alternative to the appeals Commissioners who would still determine appeals in cases where HMRC and the taxpayer could not reach agreement. Any independent actuarial report obtained during the tax enquiry would be available to assist the Commissioners' deliberations.

As discussed above, this approach would mirror the FSA's approach to the investigative process that supports their regulation of general insurance business.

Consultation with industry is ongoing on the precise wording of a revenue protection measure, how it would operate and the form of an information requirement, if it is necessary.

9. Further information

This Regulatory Impact Assessment will be updated following further informal consultation and as the policy direction develops.

Comments and requests for further information should be directed to Simon Claydon on 020 7147 2545 or simon.claydon@hmrc.gsi.gov.uk.

⁶ paragraph 27 Schedule 18 Finance Act 1998 / section 19A Taxes Management Act 1970.