

Regulatory Impact Statement

Lloyd's of London – tax simplification

Agency Disclosure Statement

This Regulatory Impact Statement (RIS) has been prepared by Inland Revenue.

It provides an analysis of options to simplify tax compliance for Lloyd's of London in connection with income earned from its proposed New Zealand term-life insurance business. Term-life insurance is directed at life risk only and does not contain provisions for policyholder savings.

The Income Tax Act 2007 contains rules that require non-resident life insurers to file and pay tax in relation to their New Zealand business. As Lloyd's trades as syndicates, these rules result in each Member of Lloyd's that does business in New Zealand having to apply for an Inland Revenue number and file annual tax returns. This would impose considerable compliance costs on Lloyd's in terms of calculating taxable income and paying tax at the Member's correct marginal tax rate. Inland Revenue would also face increased administration costs as the requirements of the Income Tax Act would generate over time a significant increase in the volume of life insurer returns that are processed and audited for tax compliance. These outcomes give rise to efficiency concerns.

The analysis in this RIS is constrained by the fact that the problem and preferred solution is limited to Lloyd's and its authorised New Zealand agents. There are wider issues concerning the treatment of life insurance sold by life insurers, including reinsurance. Given current priorities on the Government's tax policy work programme, these wider issues have not been considered in depth.

Taxpayer confidentiality provisions prevent Inland Revenue from disclosing the expected value of Lloyd's life insurance business in New Zealand. In terms of scale, the current law as it applies to Lloyd's syndicates produces compliance costs and costs on Inland Revenue that are out of proportion to the tax revenue at issue.

As the proposal affects life insurers only, consultation was limited to the Financial Services Council, the representative body for New Zealand life insurers. Inland Revenue considers that level of consultation fairly reflected the nature of the issue under consideration and those affected.

Brandon Sloan
Senior Policy Advisor, Policy and Strategy
Inland Revenue

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STATUS QUO AND PROBLEM DEFINITION

1. Lloyd's of London (Lloyd's) has regulatory approval to write term-life insurance business in New Zealand. While taxpayer confidentiality provisions prevent Inland Revenue from disclosing the expected value of Lloyd's life insurance business in New Zealand, it is a minute fraction of total life insurance premium income sold in New Zealand.¹ This business is expected to add capacity rather than substituting existing life insurance policies sold by New Zealand life insurers.

2. Lloyd's is an insurance market, not an insurance company. It is an institution where Members of the Society of Lloyd's, both corporate and individual, join together in syndicates to insure risk. These syndicates have different market specialisations and risk profiles. Over time the underwriting activity attracted capital from outsiders in a subscription market, signifying that a series of underwriters would assume shares of risk. Members are required to be United Kingdom tax residents under Lloyd's governance rules.

3. Lloyd's unique structure means that any amount of business in New Zealand would require each Members of a syndicate to obtain Inland Revenue numbers and file tax returns in New Zealand with material compliance and administration implications. The problem arises because the Income Tax Act rules for non-resident life insurers are designed with companies in mind rather than the syndicate approach used by Lloyd's. Lloyd's advises that its life syndicates in 2015 had 282 members, including 125 companies, 66 individuals and 91 partnerships. By way of comparison, Inland Revenue currently processes 58 returns from 34 life insurers.

4. The current law would generate a significant increase in the number of complex life insurance tax returns received by Inland Revenue for what would be very small amounts of tax relating to each return.

5. Under current law, non-resident life insurers are required to complete tax returns for income (less allowable deductions and losses) for life insurance policies that are:

- offered in New Zealand; or
- offered or entered into in New Zealand.

6. Non-resident life insurers can apply to Inland Revenue to file and pay tax as if they were New Zealand tax residents to the extent of their New Zealand business. Compliance by non-residents with these rules is generally excellent.

7. A different set of rules apply to non-resident general insurers (non-life insurers). Income from general insurance business that is attributed to New Zealand is deemed to be 10 percent of the gross premium. No deductions are allowed and responsibility for returning the tax falls on a hierarchy of New Zealand persons (typically the insurer's agent or the insured's broker). There are well-established practices in the general insurance industry to ensure compliance with New Zealand's tax obligations.

¹ There are 34 established life insurers operating in New Zealand, with the five largest comprising 75 percent of the life market. Total premium income is close to \$2.6 billion (2015).

8. Lloyd's has requested a legislative change that would allow income from New Zealand term-life insurance business sold by Lloyd's to be treated in a similar manner to general insurance premiums. The effect of the requested change shifts the tax compliance obligations from Lloyd's syndicates to Lloyd's New Zealand authorised agents. Lloyd's have established practices that ensure its New Zealand authorised agents comply with the obligations required by the Income Tax Act and Tax Administration Act 1994.

9. The purpose of the requested legislative change is not to provide a tax concession but improve the efficiency of tax system by significantly reducing compliance and administration costs.

10. Inland Revenue has considered whether there is a good case for changing the way that tax is calculated for life insurance sold by Lloyd's. The current legislative settings for offshore life insurers require the calculation of taxable income after adjusting for allowable deductions and losses. The rules ensure accuracy and the tax paid reflects the economic activity that has a connection with New Zealand. The trade-off is the cost of compliance on taxpayers and, for Inland Revenue, the increased volume of returns that could result.

11. There are also additional tax compliance complexities created by the way that profit is recognised by Lloyd's for each syndicate. Typically, the profits from insurance business are not fully recognised until the end of a three-year reporting cycle based originally on the period of time it took a 17th century ship to sail around the world. Consider the description below. While this reporting cycle is supported by annual interim reporting, this pattern of financial reporting does not translate well into income year concepts used in tax law and the administrative and compliance systems that hinge off that concept (such as audit, disputes and collections).

Description of Lloyd's three-year reporting cycle

Member X underwrites on syndicate 123 for the 2014 year-of-account. In November 2014, the syndicate's managing agent gives a 12-month binding authority to a Lloyd's authorised agent in country Z. Premium and claims relating to that binding authority might be processed in 2014, 2015 and 2016 but all are allocated for 3-year accounting to the 2014 year-of-account.

The managing agent maintains the premiums trust fund into which all premium is received and for which claims and other expenses are paid. No profit or loss is struck for the 2014 year-of-account at the end of 2014 (or at the end of 2015). Instead, the balance of the fund is carried forward until the end of 2016 (the 36-month point for that syndicate for that year of account). This allows time for claims to arise and liabilities to be quantified.

The profit or loss for the year-of-account is struck at the 36-month point. The syndicate "declares" the result of the 2014 year of account in 2017 and "distributes" the profits of that syndicate to its Members at that time in proportion to their participation on the syndicate. A loss will result in a cash-call to Members to make up the deficit.

OBJECTIVES

12. The **main** objective is to simplify the way tax is collected on term-life insurance business carried on by Lloyd's in New Zealand in order to improve the overall efficiency of the tax system.

13. All options are assessed against the status quo in relation to the main objective and the following criteria:

- Efficiency of compliance – the options should minimise compliance costs on Lloyd's of London.
- Efficiency of administration – the options should minimise administration costs for Inland Revenue and the government.
- Sustainability – the options should maintain the integrity of the income tax base and perceptions of fairness.

14. This RIS is solely concerned with Lloyd's and there is no intention to review the tax treatment of non-resident life insurers generally. The reason for considering a specific set of rules for Lloyd's syndicates recognises its unique governance and the need for the tax system to work efficiently within current tax policy settings.

15. There are constraints on what is practically achievable by Inland Revenue and Lloyd's. These constraints create trade-offs when considering the available options. For example, there is a trade-off between sustainability and efficiency. Sustainability considers perceptions of fairness and the integrity of the tax system. The accuracy of each option is therefore an important policy consideration in terms of a taxpayer's tax liability should bear a close relationship to profitability. The life insurance industry is no exception to this.

REGULATORY IMPACT ANALYSIS

16. Four options are considered in this RIS. They are:

- Option 1 (status quo) – Lloyd's Members return tax on their New Zealand life insurance business.
- Option 2 (treat Lloyd's syndicates as a single taxpayer) – Treat all Lloyd's syndicates that carry on life insurance business in New Zealand as one taxpayer.
- Option 3 (special presumptive tax rule) – Establish a special tax rule that imposes tax on the gross premiums of Lloyd's term-life insurance products.

17. The impact of each option is discussed below. None of the options have social, cultural or environmental impacts. All of the options considered are expected to be largely fiscally neutral relative to the status quo.

Option 1 – Status quo

18. This option would maintain the status quo. Lloyd's Members would be required to obtain Inland Revenue numbers and meet their obligations under the Inland Revenue Acts.

Efficiency of compliance

19. Lloyd's Members who carry on life insurance business in New Zealand would be required to obtain Inland Revenue numbers and file annual tax returns. It is estimated that compliance with the current law could over time create the need to produce a significant number of reasonably complex annual tax returns.² Each return would be for a very small sum of revenue. For Lloyd's, the current treatment of non-resident life insurers would impose considerable practical difficulties and compliance costs and act as a barrier to enter the New Zealand life insurance market.

Efficiency of administration

20. Inland Revenue currently processes 58 tax returns from 34 established life insurers operating in New Zealand. Faced with a significant increase in the volume of tax returns from Lloyd's syndicate Members, Inland Revenue would need to divert resource and time to manage the associated increase in return volume.

21. Inland Revenue is also concerned that the interaction of the Inland Revenue Acts and Lloyd's three-year financial reporting cycle gives rise to practical difficulties. The four-year time bar, which prevents Inland Revenue from increasing tax assessments (except in the case of tax avoidance), would make it difficult to maintain adequate audit and control across all of Lloyd's syndicate Member's profits (or losses) from business emerging over the three-year business cycle.

Sustainability

22. Given the estimated value of New Zealand business that Lloyd's expects to sell, the amount of income tax for each Member's return is expected to be low. Tax would be payable on the basis of the Member's marginal tax rate (for companies 28% and individuals between the range of 10.5% to 33%). This option ensures, however, that both resident and non-resident life insurers face the same rules and preserves perceptions about the fairness of the tax system.

23. The status quo, however, is arguably inefficient as it creates compliance and administration costs that are likely to exceed the value of any tax payable from the sale of Lloyd's term-life insurance in New Zealand. The efficiency of the tax system is therefore a concern.

Option 2 – Treat Lloyd's syndicates as a single taxpayer

24. This option would involve a legislative change that would treat Lloyd's syndicates as a single taxpayer for the purposes of the non-resident life insurance rules. Tax would be calculated on the basis of income less allowable deductions and losses, and would require the completion of an annual return. In this respect, tax liabilities would be correlated to profits from Lloyd's syndicates' life insurance business in New Zealand.

² Lloyd's has 2,100 underwriting Members, including 325 individuals, over 700 partnerships and over 1,000 companies. The figure above assumes the potential for all Members (not just those described in paragraph 3) underwriting life risk in New Zealand.

Efficiency of compliance

25. This option removes the need for Lloyd's Members to individually obtain Inland Revenue numbers and file annual tax returns. Instead, one annual tax return would be prepared for Lloyd's business activity in New Zealand. Preparation of the tax return and associated compliance would be undertaken in the United Kingdom. This would involve compilation of syndicate activities and associate consolidation of information to meet New Zealand's tax laws. While this option offers some cost efficiencies for Lloyd's, it is still compliance intensive due to the need to consolidate information across multiple syndicates.

Efficiency of administration

26. This option reduces the number of returns that Inland Revenue would be required to process. Practical concerns remain, however. The return would be an amalgam of syndicate activity and would be complex to audit and verify the correctness of any tax position in those returns. The problem with Lloyd's three-yearly financial reporting and its interaction with the four-year time bar and tax administration system generally is not addressed.

Sustainability

27. This option ensures that both non-resident and resident life insurers face the same rules. In this regard, the option protects the integrity of the tax base and perceptions about its fairness.

Option 3 – Special presumptive tax rule

28. This option involves a legislative change that would change the calculation of tax payable from the sale of Lloyd's life insurance products in New Zealand.

29. Instead of calculating tax using the approach described in options 1 and 2, a presumptive tax would be applied to the gross premiums earned by Lloyd's for any term-life product sold in New Zealand. The tax rate applicable to this income would be 28%, consistent with the current rate of company tax. The presumptive tax would be calculated on the basis of 10 percent of gross premiums. This approach is used for the taxation of general insurance sold by non-resident insurers to the New Zealand market. Tax would be calculated and paid by Lloyd's handful of New Zealand authorised agents.

Efficiency of compliance

30. This option would change the way that tax is calculated and returned by Lloyd's syndicates that carry on business in New Zealand. It shifts the cost of compliance from Lloyd's Members to Lloyd's New Zealand-resident agents. Lloyd's advises that their agents would be suitably prepared to comply with the proposed legislation under this option.

31. Part of the cost savings for Lloyd's is a result of the simplified calculation of tax and shifting tax compliance obligations to Lloyd's authorised agents. For this latter group, the cost of compliance is not anticipated to be significant as option 3 is effectively an extension of its tax compliance in connection with Lloyd's general insurance products. There would be a need for Lloyd's authorised agents to maintain records regarding the split between sales of life and non-life insurance.

Efficiency of administration

32. This option would not significantly increase the number of returns that Inland Revenue is required to process. The option would be consistent with income-year concepts used by the tax system, and Inland Revenue's audit and control systems.

Sustainability

33. Option 3 is a pragmatic response to the problem and protects the integrity of the income tax base.

34. It, however, raises a question of fairness if the option produces a tax advantage to Lloyd's that is not available to other life insurers.

35. To ensure the integrity of the tax system and perceptions of fairness, Inland Revenue considers that the deemed rate of taxable income should be reviewed periodically. This is discussed in more detail under the heading "Monitoring, evaluation and review".

36. This option is not as accurate as options 1 and 2 for calculating tax that should be paid by Lloyd's in connection with its New Zealand term-life insurance business. There is a risk that treating 10 percent of gross premiums as reflecting Lloyd's profit from New Zealand would either overstate or understate taxable income. At least initially, it is likely that tax paid on Lloyd's business activity in New Zealand would be higher than what would otherwise be payable under the status quo or option 2. This is a trade-off for simplifying Lloyd's tax compliance.

37. It is relatively uncommon to have specific rules in the Income Tax Act for a specified group of taxpayers. In this particular case, the use of a syndicate structure for insurance does not fit within the conventional taxation rules for life insurance business. Tax and regulatory authorities in New Zealand, Australia and elsewhere recognise that Lloyd's does not fit within normal frameworks or rules. There are several examples of special rules and administrative arrangements to ensure proper compliance with regulators and the payment of taxes.³

CONSULTATION

38. Inland Revenue wrote to the Financial Services Council (FSC) seeking its views on option 3. The FSC is the industry representative group for most insurers operating in New Zealand.

39. Private sector consultation was limited to the FSC as the matters discussed in this RIS solely concern a new life insurer entering the New Zealand market. No other private sector groups with an interest in this issue were identified. The scale of the issue did not warrant extensive consultation using the generic tax policy process.

³ For example, provisions in the Insurance (Prudential Supervision) Act 2010 and the Financial Markets Conduct Act 2013 and the Financial Services Providers (Exemption) Regulations 2010. In a New Zealand tax context, there were specific provisions that were largely directed at Lloyd's underwriters – former sections 210 and 210A of the Income Tax Act 1976. In Australia, provisions concerning Lloyd's are found with the Income Tax Assessment Act 1936 the Corporations Act 2001 and the Australian Prudential Regulation Authority Act 1998 and the Financial Institutions Supervisory Levies Collection Act 1998.

40. The FSC's comments on option 3 and Inland Revenue's response are set out below:

- Option 3 could provide a competitive advantage to a new entrant. The FSC noted that the current rules require all life insurers whether New Zealand resident or not to comply with the same rules to ensure that a tax concession is not available to a particular life insurer.

Inland Revenue is reasonably confident that the proposed presumptive tax provides a reasonable proxy of profitability and, given the niche markets that Lloyd's syndicates' intend to operate, the risk that option 3 provides Lloyd's with an unfair competitive advantage is considered to be low. This will be the subject of regular monitoring.

- Whether option 3 should apply to all non-resident life insurers including reinsurers. The proposal for Lloyd's raises broader questions relating to the basis on which life insurance business by, and with, non-resident life insurers are taxed.

Inland Revenue agrees that the proposal raises the possibility for wider consideration of the treatment of life insurance and life risk sold by life insurers, but notes a potential for fiscal risk. The priority of any future work on these matters would be considered as part of the tax policy work programme.

- There are a number of technical issues with option 3, particularly relating to its detail. These issues relate to who bears the liability for tax, the type of life insurance product the option would apply to, and the frequency of any review of the deemed rate of taxable income on which option 3 is based.

The technical matters raised in submissions confirmed the need to confine option 3 to the sale of term-life insurance policies and that the deemed amount of taxable income of 10 percent be reviewed. As discussed, the obligation to calculate and pay tax would fall on Lloyd's New Zealand authorised agents.

41. The overall message from consultation was an acknowledgement a compliance problem exists and we infer that the FSC reluctantly accepts option 3. The FSC did not express any outright opposition to option 3.

42. Lloyd's was also consulted and supports option 3.

43. Inland Revenue also sought comment from the Treasury and the Reserve Bank. Both note that the costs imposed by the current law (status quo) are disproportionate to the tax revenue at issue.

CONCLUSIONS AND RECOMMENDATIONS

44. The table "summary of options and analysis" below summarises the assessment of each option described in this RIS. The following symbols are used to describe if the option improves on or is worse than the status quo.

- PP Significantly better than the status quo
- P Better than the status quo
- O No better than the status quo
- OO Worse than the status quo

Table 1: summary of options and analysis

Options	Analysis against the objective and criteria
Option 1 – Status quo	Does not meet the main objective
Option 2 – Treat Lloyd’s syndicates as a single taxpayer	Meets the main objective in part. Efficiency of compliance P Efficiency of administration O Sustainable O
Option 3 – special presumptive rule	Meets the main objective Efficiency of compliance PP Efficiency of administration PP Sustainable O

45. Inland Revenue supports option 3. This is because out of all the options, it represents the greatest improvement over the status quo.

46. Option 3 may not be fiscally neutral when contrasted against the status quo or option 2. It is possible that option 3 could over or underestimate the amount tax that would be payable. This is a trade-off for the expected compliance and administration cost savings that do not arise under the other options.

IMPLEMENTATION

47. Legislative change to the Income Tax Act and possibly the Tax Administration Act are necessary to implement option 3. These amendments would be included in the first omnibus taxation bill for 2017.

48. The changes would apply to term-life insurance sold by Lloyd’s syndicates on and after 1 April 2017 to align with Lloyd’s proposed entry into the New Zealand life insurance market.

49. When introduced into Parliament, a *Commentary* on the bill will be released explaining the amendments. Further explanation about their effect will be contained in Inland Revenue’s *Tax Information Bulletin* series, which would be released shortly after the bill receives Royal assent.

50. Inland Revenue would administer the proposed legislative changes. Enforcement of the changes would be managed by Inland Revenue as business as usual.

51. The proposed change aligns with Inland Revenue’s existing technology and business systems. Additional information may be sought from affected Lloyd’s authorised New

Zealand agents as to the breakdown of premiums from Lloyd's life and non-life insurance products.

52. Lloyd's will work with affected New Zealand authorised agents to ensure they are informed about the practical day-to-day impact of the changes. Lloyd's advises that its New Zealand authorised agents are generally familiar with the rules that apply to the sale of Lloyd's non-life insurance products and the proposed legislative change is an extension of those rules. Lloyd's authorised agents would be expected to prepare the same IR4 returns as currently required.

MONITORING, EVALUATION AND REVIEW

53. In general, post-implementation reviews are a feature of the generic tax policy process (GTPP). The GTPP is a multi-stage policy process that has been used to design tax policy (and subsequently social policy administered by Inland Revenue) in New Zealand since 1995.

54. The final step in the process is the implementation and review stage, which involves post-implementation review of legislation and the identification of remedial issues. Opportunities for external consultation are built into this stage. In practice, any changes identified as necessary would be added to the tax policy work programme, and proposals would go through the GTPP.

55. If the Government adopts option 3, Inland Revenue recommends that the presumptive tax be reviewed in 2020 to assess its on-going suitability and whether it broadly reflects Lloyd's syndicates' profit based on financial reporting evidence for the period 2017-2019 and projected future profitability. Notwithstanding accuracy matters, if the compliance and administration savings are sufficiently material, unders and overs in tax payable are likely to be tolerated. Compliance cost implications for Lloyd's authorised agents would also be considered as part of the review in 2020.