

Prime Minister

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You need only read the P. U. note itself. An esoteric issue -

but there is no point in damaging the City through

MR POTTER

25 May 1990

ounguous tax practice. Moreover there is a clearance that the UK might change the practice, if long time in favour of the Treasury.

THE BERMUDA PROTECTION AND INDEMNITY ASSOCIATIONS

Content to pursue
X/with the Treasury?

The Prime Minister may be interested in a tax issue with potentially important implications for London as a shipping and finance centre.

Protection and Indemnity Associations ('P&I Clubs') are the means by which ship owners insure themselves against third party liabilities to which they are exposed as ship operators. They work on a mutual, non-profit making basis. Three are in Scandinavia, one in Japan, one in the USA, six in the UK, two in Luxembourg and three in Bermuda. The three Bermuda Clubs left London in 1970 because of the problems of exchange control. This was done with Treasury and Bank of England agreement and the Bermuda managers made contracts with the previous London managers for the continuing provision of professional services. The UK P&I Clubs pay corporation tax on their investment income (but not on any surplus in one year) but the Bermuda Clubs have not received any assessment for that until this year. It was assumed that they were not liable to do so because the management function was carried on in Bermuda not in London.

The Inland Revenue has this year issued an assessment on the investment income of the year 1983/4 arguing that the Clubs are liable because their London managers' representatives are in practice branches or agencies of the Clubs themselves, through which they trade. The Clubs rebut this assertion and it will be tested in the courts but, whatever the outcome, there is concern that the Clubs' directors and managers will react to the attempted reversal of their 20 year freedom from involvement in a UK tax system by going elsewhere. That threatens 500 jobs and revenues in excess of £30m per annum; but the real issue is the uncertainty which the situation creates for all those businesses which provide advisory and administrative services for overseas customers. The financial services industry in particular is concerned that the tests of trading through a branch or agency in the UK are far less clear than those that are applicable to the traditional 'mind and management' test and that they will be a disincentive to buy London services.

a letter to Mr Heseltine of 6 February the Chancellor said that "if it turns out that the clubs do have to pay tax here as their business is currently conducted, then I will of course be prepared to consider the case for a change in the law in their favour. But it would be premature to do so while the current legal position and the precise consequences in terms of tax due remain unsettled". That legal process could take several years with damaging business consequences. The interested parties have therefore submitted for the consideration of the financial secretary a clause for inclusion in this year's Finance Bill. It is set out in Annex A.

When, in 1988, the Inland Revenue issued a Green Paper on 'Residence in the UK' it caused considerable concern because of its likely effect on the position of non-domiciled UK residents in particular. Greek ship owners, amongst others, were thought likely to leave the United Kingdom if the proposals were enacted and I believe that the Prime Minister was seriously concerned about the damage which the UK economy would suffer in consequence. This is a rather similar issue and she may feel that the Treasury should be asked to give sympathetic consideration to the idea of a clause in the Finance Bill which would define the future position of the Clubs in particular and, by inference, all those who provide advisory services to foreign companies from London.

Annex B is a fuller note on the legal issues.

Yes - I.e.

Howell Harris Hughes

HOWELL HARRIS HUGHES

Proposed by won in the

Combs would damage U.K.

business seriously, we should

need to move it in this years Finance Bill

On in any event - put a clause in this F.B. to
clarify the position

ANNEX A

"Where a person or body of persons not resident in the United Kingdom carries on a business of mutual insurance which is general business within the meaning of the Insurance Companies Act 1982 the provisions of the Tax Acts shall apply to profits or gains derived from assets in respect of which a profit on their sale would form part of the profits of that business as if such profits or gains were derived from a trade carried on by the person or body of persons as a trade separate from its business of mutual insurance."

The Bermuda P&I Clubs and the Inland Revenue - Fact Sheet.

Issue	Are the shipowners' mutual protection and indemnity associations which are resident in Bermuda subject to UK taxation on their world-wide investment income on the basis that, by virtue of the fact that certain day-to-day aspects of their operation are sub-contracted to insurance professionals in London, they are trading in the UK through a branch or agency?
Protection and Indemnity Associations	Protection and Indemnity Associations - commonly known as P&I clubs" - are the means by which the world's Associations shipowners insure themselves in respect of the third party liabilities to which they are exposed as ship-operators, including claims for pollution, collision, dock damage, wreck removal, cargo loss and damage, custom fines and death of or injury to crew, passengers, stevedores and other persons. There are 16 or so such Associations in the world, covering collectively over 90% of world deep-sea shipping. This note is concerned only with the three associations that are resident in Bermuda.
History of the Bermuda based Associations	The three Bermuda-based Associations are the following:- The Standard Steamship Owners Protection & Indemnity Association (Bermuda) Limited. The Steamship Mutual Underwriting Association (Bermuda) Limited. The United Kingdom Mutual Steam Ship Assurance Association (Bermuda) Limited. They were established in Bermuda in 1970, 1974 and 1969 respectively. They were largely composed of shipowners who had previously been entered in UK resident associations. These UK resident associations suffered from the major commercial disadvantage that they were subject to exchange control. That meant that most of the premiums received by them had to be held in sterling and were therefore subject to any decline in the international value of that currency. As, even in those days, more than 80% of the shipowners concerned were nationals of countries other than the UK and the majority of claims were incurred in non-sterling currencies, this constraint was regarded as insupportable. Hence, with the consent of the Treasury and the Bank of England, the shipowners in effect transferred the business to Bermuda, where new associations were established as exempt companies, subject neither to exchange control nor to any but nominal local taxes.

Structure

Each of the Bermuda Associations engaged an independent firm of managers in Bermuda to provide the necessary administration. The managers in turn contracted with the previous managers of the UK resident associations or, in the case of the Steamship Mutual Association, with the UK-based association itself, for the provision of support services.

Mode of operation
- financial

A Protection and Indemnity association is composed of members who are all shipowners or ship operators. All the members are insured by the association. In this respect an association resembles a co-operative. Since, generally, it does business only with its members, it operates on a non-profit making basis. For each underwriting year it tries to achieve a result whereby premiums plus investment income equal claims plus expenses. An exact balance is impossible to achieve; if in one year there is a surplus, it is either returned pro rata to the members insured for that year or taken to reserves lest there be a deficit in a following year. If a deficit arises in a given year, that is met either by a transfer from reserves (if there are any) or by an additional levy pro rata on the members for that year.

Mode of operation
- structural

The policy of the association is determined by its Board of Directors who are elected from and by the shipowner members. This Board will meet at least quarterly in various shipping and commercial centres around the world, including Bermuda, but not in the UK. Although, as stated above, the Board makes all decisions of policy, the day-to-day work of running the association is delegated to the managers in Bermuda. They exercise, - subject always to the policies laid down by the Board and to its supervision and control - the Directors' powers, for example, to accept entries into the Association, to reimburse members for payments made by them in settlement of claims against them insured by the association and to invest the funds of the association pending their disbursement. The managers themselves engage specialist professional firms in London and in certain cases elsewhere to perform much of the preparatory work involved in agreeing terms and conditions for the entry of ships in the association and also the handling of claims brought against the members, often in conjunction with the other correspondents of the association, surveyors, lawyers and other consultants. The London firms have no power to accept entries into the association nor to pay claims and expenses on behalf of the association, the decisions in this respect being taken always by the

Bermuda managers. They have no involvement whatever with the investment of the association's funds. Management of the Association's investments takes place wholly outside the UK. The three London firms employ about 500 people between them.

Market share

The three Bermuda associations together represent about 45% of the world's Protection and Indemnity market. The ships insured with them come from over 80 different countries and have a gross register tonnage of about 180,000,000. Last year the cost of claims shared by the members of these associations amounted to about US\$400,000,000. Last year the Bermuda managers paid the London firms approximately US\$30,000,000 for the services they provided and that figure will rise substantially this year.

The Revenue's review of 'the P and I sector'

The Inland Revenue are currently embarked on a review of what it calls 'the Protection and Indemnity association sector'. In its earlier stages this review covered certain associations resident in Luxembourg which have their management subsidiary companies located in the UK. In its subsequent review of the Bermuda associations, the Revenue have regarded their position as analogous to that of the Luxemburg associations. In adopting this approach the Revenue are choosing to ignore the crucial difference in structure between the two sets of associations; whilst the management companies of the Luxemburg clubs are based in the UK, the management of the Bermuda associations is based in Bermuda and draws on the UK only for certain defined services as already described.

Revenue awareness of the position

The operational structure of the Bermuda associations has been discussed with the Revenue on more than one occasion over the past twenty years, the last such occasion being in 1981/83 in relation to the Revenue paper on Taxation of International Business. No objection was taken to the arrangements on any such occasion and no assessments had ever been issued against the associations or their managers until the 20th February this year, on which date the Revenue issued assessments for the 1983/84 year in order to prevent any claims for tax in respect of that year becoming time-barred.

Licences under
the Insurance
Companies Act

The Revenue have ascribed their recent interest in the Bermuda associations in part to the fact that during 1988 the associations obtained from the Department of Trade and Industry a licence under the Insurance Companies Act 1982. This move was in no way related to any change in the associations' methods of operation. It was simply a precaution taken in the light of the judicial interpretation of the Insurance Companies Act in cases decided in the early 1980s which interpreted the statute in a way not previously anticipated by the insurance industry or, indeed, the DTI. There was considerable discussion with the DTI on the question whether or not the associations should seek a licence under the Act; eventually, the associations accepted the advice of the DTI to seek a licence, but reserved their position as regards the legal necessity of so doing.

The position
in law

It is accepted law in the UK that mutual associations are not taxable on their underwriting surpluses. In the case of UK resident associations, they will however be taxable as UK residents on their investment income. In the case of associations not resident in the UK such as the Bermuda associations, the law is much less certain; there are no statutory provisions or legal precedents that cover the point precisely. Eminent tax counsel jointly advising the Bermuda associations have stated that, in their view, the Inland Revenue's claim for corporation tax against the P&I Clubs is extremely doubtful. They conclude that there are a number of formidable hurdles that the Inland Revenue would have to surmount and that it is unlikely that the Inland Revenue would surmount them all.

The consequences

If the Revenue proceed with their assessments against the Bermuda associations, the likelihood is that three consequences will flow:-

Legal contest

1. The associations will contest the assessments with all the strength at their command.

Loss of invisible
exports

2. The associations will require their managers in Bermuda to cut the London connections and buy from elsewhere the services they presently buy from London. A direct consequence will be the loss of invisible export earnings generated by the three London firms, together with the tax revenues of some £6 million to which they currently give rise. Considerable redundancies in those firms will be inevitable. In this connection the largest of the London firms has already received notice to terminate its appointment.

Adverse reaction
of the
international
shipping and
trading
community

3. Foreign enterprises will be counselled to curtail the services they presently buy from London or to cease to buy them altogether. Foreign enterprises needing services such as London can provide will strike the UK from their list of possible options. The reassurance that the international community drew from the government's recent decision to shelve the Revenue's consultative paper on "Residence in the United Kingdom" will be lost.

The financial consequences for the UK are likely to be very serious. A report entitled 'Impact on the UK Economy of the Inland Revenue's Move against the Bermuda Protection and Indemnity Associations' points out that the present approach of the Inland Revenue is widely perceived as representing a significant reduction in the range of activities that can be performed in the UK for foreign clients without exposing them to UK tax. In consequence, foreign enterprises will increasingly lose confidence in the UK as a supplier of services to the extent that in the longer term up to £1.4 billion p.a. of overseas earnings could be put at risk. Thus the Revenue's approach is clearly seen as detrimental to London's position as an international services centre, and of substantial benefit to competing venues abroad.

14th March, 1990