

# MARKET BULLETIN

<b>From</b>	Senior Tax Manager Taxation (extn 6839)
<b>Date</b>	14 November 2005
<b>Reference</b>	Y3672
<b>Subject</b>	<b>UK Tax- Transfer Pricing</b>
<b>Subject areas</b>	Guidance on the Application of the UK Tax Legislation to the Lloyd's Market
<b>Attachments</b>	HM Revenue & Customs Guidance
<b>Action points</b>	For Information
<b>Deadlines</b>	None

With effect from April 2004, the transfer pricing legislation in Schedule 28AA ICTA 1988 applies to transactions between two UK connected persons as well as to transactions between UK and overseas persons.

Following consultation with Lloyd's and market advisers, HM Revenue and Customs has prepared the attached guidance note on the application of the UK to UK transfer pricing rules to transactions within the Lloyd's market (see Appendix). This is intended assist those Lloyd's market entities who need to consider transfer pricing when preparing their 2004 and subsequent tax returns. HM Revenue & Customs has also indicated that it will consider sympathetically any practical issues or difficulties that may arise in relation to any proposed adjustments to syndicate tax results in circumstances where that result has already been determined.

This bulletin is being issued to managing agents, members' agents, recognised auditors and direct corporate members. If you have any questions, please contact:

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**Transfer Pricing**  
**Practical Application of the new UK to UK Transfer Pricing Legislation in the**  
**Lloyd's Market**

**1. Introduction**

- 1.1 Pre 2004, transactions between UK persons were exempt from the transfer pricing provisions contained within Schedule 28AA ICTA 1988. However, the Finance Act 2004 removed this exemption with effect from April 2004, with the result that transfer pricing must also now be applied to wholly UK-UK transactions between connected parties as well as to UK - overseas transactions.
- 1.2 In a nutshell the transfer pricing rules exist to ensure that individual group members are taxed on the basis that they act at 'arm's length' in their dealings with each other.<sup>1</sup> Where the terms applying to a particular transaction between two UK group members are not comparable with those that would have applied at arms length then transfer pricing adjustments will be necessary in the tax computations of the parties to the transaction.
- 1.3 Detailed guidance on the transfer pricing rules can be found in the HMRC's '*International Manual*', from para. INT430000 onwards.
- 1.4 The new rules will be relevant to the Lloyd's market in a variety of circumstances. This paper is designed to provide the market with some general guidance indicating how the new legislation should be applied in some specific circumstances. In particular, it is designed to illustrate how the rules and practices within the market will, in many instances, set the 'arms length' framework for particular types of transactions. This will help members identify those circumstances in which no transfer pricing adjustments are necessary, or alternatively an appropriate basis for making such adjustments. Equally, it will help to identify those circumstances in which, because of some departure from the normal rules and practices, the arm's length test will have to be applied on a case specific basis.
- 1.5 The paper covers the following areas:-
- Background to the Lloyd's Market (Section 2)
  - Application of transfer pricing legislation (Section 3)
    - Lloyd's Market Entities
    - Timing of compensating adjustments
    - Risk assessment
  - Managing Agent's fees, Profit Commissions & Expenses (Section 4)
  - Service Companies (other than Coverholders & Brokers) (Section 5)
  - Coverholder Service Companies (Section 6)
  - Brokers (Section 7)
  - Reinsurance to Close ('RITC') (Section 8)

1.6 The treatment of reinsurance transactions generally (i.e. other than RITC) and of the provision of guarantees and letters of credit is outside the scope of this paper. This is because such arrangements are invariably bespoke arrangements suited to particular circumstances and group structures. As such the implications of the new transfer pricing rules will need to be considered on a case by case basis.

1.7 Key points are:-

- (a) where transactions are with a spread syndicate the prices paid by or to the spread members should provide a comparable uncontrolled price (CUP) for the prices paid by or to any aligned members of the same syndicate;
- (b) fees and profit commissions should be looked at together, rather than separately;
- (c) fees and profit commissions charged by managing agents to spread syndicates could be used to support fees and profit commissions charged to wholly aligned syndicates (although consideration should also be given to the fact that managing agents of spread syndicates may be remunerated at a higher rate to reflect the increased cost of administration and greater risk). In some cases another transfer pricing methodology such as cost plus may be more appropriate;
- (d) where fees and profit commission are at arm's length no adjustment should be made to expenses charged by managing agents to syndicates;
- (e) with respect to administrative service companies (i.e service companies other than coverholders or brokers), any transfer pricing adjustment should only affect the provision between the service company and the managing agent. No transfer pricing adjustment should be made to the member's tax returns. A cost plus methodology applied to some of the costs (e.g. the costs of the senior management) may be appropriate;
- (f) with respect to coverholder service companies, the transfer pricing should look at the position between the service company and the Lloyd's syndicate. In some circumstances there may be CUPs for the provision of coverholder services;
- (g) Lloyd's brokers are unlikely to be in the same group for transfer pricing as members of a syndicate. If, in exceptional circumstances, they are, normal transfer pricing principles should apply;
- (h) no circumstances can be thought of where a transfer pricing adjustment should be made to an RITC.

## 2. Background Information

- 2.1 Lloyd's is an insurance market. The Society of Lloyd's is a statutory corporation, incorporated as Lloyd's under a UK Act of Parliament, Lloyd's Act 1871. The objects of the Society include "the carrying on by Members of the Society of the business of insurance of every description including guarantee business". The objects of the Society do not include the carrying on of insurance business by the Society. The Society is not authorised to underwrite insurance business.
- 2.2 The Council of Lloyd's (established by Lloyd's Act 1982) is the Society's governing body. It has control over the management and regulation of the affairs of the Society of Lloyd's. The Council has the power to manage and supervise the affairs of the Society, to regulate and direct the business of insurance at Lloyd's and to exercise all the powers of the Society. The Council also has power to make such byelaws as it thinks fit to further the objects of the Society.
- 2.3 Lloyd's underwriting members, both individuals and corporates, write insurance business through syndicates. Syndicates are not themselves legal persons. Each Lloyd's syndicate is an annual venture. The year in which it writes business is called a year of account and members will have no liability for business underwritten by the same syndicate in previous years of account unless they were members in that particular year or they have reinsured the members participating on another year of account via the "reinsurance to close" ("RITC") mechanism. Membership of a syndicate can change from year to year and the proportion of business underwritten by a member can also change each year. Due to this changing composition the managing agent owes a duty of care to maintain equity between the members of a syndicate year of account and between members participating on the same syndicate but on different years of account. This principle also needs to be maintained when closing a year of account via RITC. Further reference is made to these principles later in the paper.
- 2.4 Some syndicates have a number of members, which may be a mix of individuals and corporates. These are known as spread syndicates. An aligned member is one which is in the same group as the managing agent. A wholly aligned syndicate is one whose only member, or members, consist of companies in the same group as the managing agent.
- 2.5 Members are not permitted to underwrite insurance other than through a managing agent. Members delegate to the managing agent all responsibility for the management of their underwriting business on the relevant syndicates.
- 2.6 A managing agent may manage several syndicates, which may have different memberships. The managing agent is responsible for, amongst other things, determining the underwriting policy; accepting the underwriting risk and agreeing and settling all claims against the syndicate. Other functions of the managing agent include the negotiation and management of syndicate

reinsurances, the management of the investment of premiums, the management and control of expenses and the employment of underwriting staff.

### **3. Transfer Pricing**

#### **3.1 Application of the transfer pricing legislation to entities in the Lloyd's market.**

- 3.1.1 As syndicates are not legal persons and as the transfer pricing legislation contained within ICTA 1988 Sch 28AA applies only to "persons", the legislation is not capable of applying to a syndicate as such.
- 3.1.2 However, the members, whether corporates or individuals, are "persons" and therefore transfer pricing may apply to some transactions whether the transaction is carried out at syndicate level or directly with the member, due to the fact that members are subject to tax on their proportionate share of the syndicate's profit.
- 3.1.3 Sch 28AA applies to transactions where one of the parties to the transaction is "directly or indirectly participating in the management control or capital of the other," or where the same person or persons is "directly or indirectly participating in the management, control or capital" of each of the parties to the transaction. Individual private members (whether unlimited or Namecos) will not usually be directly or indirectly participating in the management, control or capital of the Managing Agent (unless they hold significant shares and/or participate in the management at a senior level) and therefore individual members should not normally need to consider the application of transfer pricing in relation to transactions with a Managing Agent. It is also true to say that the smaller corporates who participate on spread syndicates are unlikely to be connected (for the purposes of Sch 28AA) to the managing agent. Schedule 28AA also contains provisions to exempt small and medium enterprises from the legislation, and therefore the remainder of this paper focuses on the larger corporates, who are most likely to be affected by the new provisions.

#### **3.2 Compensating Adjustments**

- 3.2.1 Where the parties to a transaction are connected as defined within Sch 28AA, the legislation requires the "advantaged person" to adjust their pricing for tax purposes to that which would have been charged had the transaction taken place between third parties. The advantaged person is the person to whom a "potential advantage in relation to United Kingdom tax is conferred by the actual provision", i.e. their profits are smaller or their losses are larger than they would be have been if arm's length pricing had been applied.
- 3.2.2 Para 6 Sch 28AA allows compensating adjustments to be made in the disadvantaged person's tax return (if they are also subject to UK tax) to mirror the effect on the advantaged person of being required to make an adjustment to the pricing for tax purposes under Sch 28AA. This is the case even if the

normal time limit for amending the tax return has passed. Para 6 Sch 28AA provides that the disadvantaged person has two years from the date the advantaged person makes the return containing the relevant transfer pricing adjustment in which to make their claim for the compensating adjustment.

- 3.2.3 It should also be noted that because (with the exception of discounting adjustments which are specifically provided for in s107 FA 2000) a member's taxable result from syndicate transactions is finally determined as part of the syndicate's taxable result, any transfer pricing adjustment in relation to syndicate level transactions will need to be included in the syndicate's tax return that is made by the managing agent.

### Balancing Payments

- 3.2.4 The legislation (para 7A Sch 28AA) also allows for 'balancing payments'. These will enable a business that is entitled to a compensating adjustment to pass the cash effect back to the related business that has received a transfer pricing adjustment.

### 3.3 Risk Assessment

- 3.3.1 When HMRC receives the annual tax returns, accounts and tax computations of corporate members it reviews the information provided, and any other relevant information, to see whether there is any evidence that tax might be at risk. This risk assessment determines whether an enquiry is made.

- 3.3.2 In the context of transfer pricing, whether cross border or UK-UK, the risk assessment involves a consideration of:

- whether the transfer pricing rules have been applied correctly; and
- the arm's length plausibility of any connected transactions and/or arrangements.

Specific transfer pricing risk factors include, for example, transactions between group members that appear to exploit differences in tax rates or the availability of losses or other reliefs.

- 3.3.3 Providing the new UK-UK transfer pricing rules are applied correctly by corporate members and other Lloyd's market entities there is no reason to believe that they will result in a material increase in HMRC enquiries. As with cross border transfer pricing, HMRC's main priority will be to identify those cases in which a group relationship is exploited to secure a material tax advantage, not arrangements at the margins of arm's length plausibility. It will be easier for HMRC to take a clear view on the nature of the transfer pricing risks in any particular company if any relevant transactions are clearly identified and the view taken on the application of the transfer pricing rules to those transactions is clearly set out. This might be, for example, by way of a footnote in the tax computations.

3.3.2 The remainder of the paper talks about specific transactions which have been identified within the Lloyd's Market.

#### **4. Managing Agent's Fees, Profit Commissions and Expenses**

##### **4.1 Legal**

4.1.1 Lloyd's Agency Agreements Byelaw (No. 8 of 1988) ("Agency Byelaw") para 3 states that managing agents can only underwrite insurance business on behalf of an underwriting member if they have entered into a standard managing agent's agreement ("Standard Agreement")<sup>2</sup>. The terms of the standard agreement may only be varied with the written consent of the Council of Lloyd's<sup>3</sup>.

4.1.2 The Council of Lloyd's has the power to prescribe from time to time the manner in which, the intervals and the times at which managing agent's fees and profit commissions are to be paid. The standard agreements for corporate members, which are attached as Schedule 3 and 4 to the Byelaw, contain a number of provisions in Schedule 1 relating to the determination of the basis of the managing agent's annual fee and the parties to the agreement may incorporate whichever one of the permitted alternatives they agree upon.<sup>4</sup> Likewise, Schedule 1 of the standard agreement ("Schedule 1") allows a rate to be specified at which remuneration by way of fee or profit commission is paid by the member to the managing agent. Schedule 1 does not however specify rates for either fees or profit commission, but fees are usually based on the member's syndicate premium limit and the profit commission is usually a percentage of the corporate member's adjusted profit for the corresponding year of account. The member and managing agent can however agree that fees and/or profit commissions should not be provided for in the agreement.

4.1.3 Paragraph 5(9) of the Agency Byelaw requires that for any given year of account the same provision for profit commission and fees shall apply to the managing agent's agreement between the managing agent and each member of the syndicate, thereby ensuring that all the members participating on a syndicate are treated equitably. Paragraph 13 of the standard agreement states that the agent shall not in the performance of its duties under the agreement discriminate between or treat differently in any material respect the member whom the agreement is with and any other member or members of the syndicate, again ensuring that all members on a syndicate are treated equitably.

4.1.4 Lloyd's keeps a central register of underwriting agents' charges, and prior to the year end a managing agent must supply to Lloyd's particulars of fees and profit commissions for the following year. If a managing agent wants to amend the level of fees or profit commission from that specified in the

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<sup>2</sup> Agency Agreements Byelaw (No 8 of 1988) para 3

<sup>3</sup> Agency Agreements Byelaw (No. 8 of 1988) para 5(1)

<sup>4</sup> Agency Agreements Byelaw (No. 8 of 1988) para 5(3)

managing agent's agreement it must terminate the existing agreement and enter into a new agreement with the members. In order to do this notice must be given to the Council of Lloyd's in writing.

- 4.1.5 Paragraph 4 of the standard agreement details the duty of care and fiduciary duties owed to the members by the managing agent. The managing agent must not allow its personal interests to conflict with the obligations owed to the member. The managing agent must also account to the member for any gain or profit it receives directly or indirectly in connection with the performance of the managing agent's agreement otherwise than expressly permitted by the agreement.
- 4.1.6 Part B to Schedule 1 of the Standard Agency Agreement details how the profit of each member should be calculated for the purposes of computing the profit commission due. It also sets out the rules on taking into account prior year losses in calculating the profit commission for the year of account.
- 4.1.7 In addition to fees and profit commission, paragraph 13.4 of the Agency Byelaw allows the managing agent to debit to the member's account a proportionate amount of expenses and outgoings that in the agent's opinion ought to be met by the members of the syndicate.
- 4.1.8 The standard agreement provides that these expenses must be necessary and reasonable. Paragraph 6 of the Syndicate Accounting Byelaw requires the managing agent to make a written statement of its policy relating to the allocation of syndicate operating expenses. This statement needs to contain the nature of "all such necessary and reasonable expenses" which will be charged to the members of the syndicate. It also needs to state on what basis the expenses will be allocated or apportioned to the members, and if it is not proposing to follow the guidelines set out in the Code of Practice ("COP") for Underwriting Agents on Syndicate Expenses then it needs to state why. Managing Agents who are charging a one-stop fee are not required to follow this COP. The COP also does not apply to wholly aligned syndicates.
- 4.1.9 The COP referred to above, contains, in annex 1, examples of expenses which are considered acceptable, e.g. salaries, interest and processing costs.

#### 4.2 Processes

- 4.2.1 Lloyd's Market Bulletin Y3533, dated 30 March 2005, sets out the process which must be entered into if a managing agent wishes to increase the level of fees or profit commission charged to the member under the managing agent's agreement, by terminating the agreement and entering into a new agreement with a different level of fees/ profit commission. The managing agents need to apply to Lloyd's Admissions Department ("Admissions") by no later than 30 April for conditional consent to terminate the agreement. They must then submit a full application, detailing the proposed increase. The Market Bulletin sets out in more detail additional information which needs to be provided. The same procedure does not need to be adopted if the fees or profit commission

are to be reduced, as Lloyd's approval is not required. However, the managing agent will still be required to notify Lloyd's of the new rates.

- 4.2.2 Lloyd's Admissions Department is not a fee setter, but it does have regard to whether the correct process has been adopted to support the level of fees, and in the case of a wholly aligned syndicate it will consider whether the fees are excessive. In the case of a spread syndicate, managing agents must notify the members of the proposed change and the members are then given 21 days to make representations to Lloyd's if they disagree. In considering whether approval can be given Admissions will ensure that the managing agents have notified the members of the changes and have given the members the opportunity to disagree with the fee increase, and will ensure that each member of the syndicate is being charged the same level of fees in proportion to their syndicate premium limits/ syndicate profits as applicable. The managing agent, in making the application to Admissions, must set out the reason for the increase in fees and/ or profit commission and details of discussions that have taken place with members' agents and members. Provided a valid reason has been given for the fee increase on a spread syndicate and the members have not raised any objections (or objections have been raised but Lloyd's believes the increase is justified) approval will be given by Admissions for the increase.
- 4.2.3 In the case of wholly aligned syndicates the equity between members consideration is not relevant, given that the member or members participating on the syndicate are within the same group as the managing agent. In this case, Lloyd's still has regard to the protection of the solvency position of both the members and the Society as a whole and may want to ensure that excessive fees are not being charged. Because of this, managing agents of wholly aligned syndicates still have to obtain conditional consent to terminate agency agreements and in doing so need to provide Lloyd's with details of the proposals, including budgets supporting the fee increase. Admissions can then reject the application to increase fees/ profit commission if in their view the proposed fees and /or rate of profit commission are not supported by the submission. There have been occasions when Admissions have refused a request to increase fees/ profit commissions, where the business plans and budgets did not support the increase or the correct process for increasing fees had not been gone through.
- 4.2.4 It should be noted that Admissions will only have regard to increases in the level of fees and profit commission and will not consider reductions.
- 4.2.5 There have been instances in the past where Lloyd's has allowed managing agents to waive their right to profit commission from some members. Although the Agency Byelaw requires that for any given year all members of a syndicate should be subject to profit commission on the same basis, Lloyd's recognises that it may in some circumstances be possible to reduce the profit commission charged to aligned members without any adverse effect to the non-aligned members. On this basis some consents have been given allowing the rate of profit commission to be reduced to nil.

### 4.3 Transfer Pricing approach.

- 4.3.1 In the case of spread syndicates, managing agents have to discuss possible increases in profit commission and fees with members/member's agents and members are then given 21 days to make representations to Lloyd's if they disagree. As in this case parties to the transaction are not connected, no transfer pricing adjustment is necessary. Admissions take the view that these prices are at arm's length and this is why they only have regard to whether a valid reason is given for an increase and the correct process has been gone through.
- 4.3.2 As stated above, Lloyd's Byelaws require all fees and profit commissions to be charged to all members of the syndicate on the same basis, and provided any aligned members are charged the same rate of fees/profit commission as spread members then these should also be regarded as being at arm's length. In other words, the fees/profit commission charged to the spread members could be regarded as a comparable uncontrolled price ("CUP") supporting the pricing between aligned members and the managing agent. The only exception would be where a differential pricing arrangement was in place, for example if the managing agent had waived its right to receive profit commission from aligned members. If such an amendment was made, all other things being equal, then an appropriate price for transfer pricing purposes may be the price charged to the spread members of the syndicate.
- 4.3.3 Where the syndicate is wholly aligned, although there is no CUP between the managing agent and the members of that particular syndicate, it could still be possible to use prices charged by managing agents of spread syndicates to support the transfer pricing adopted by the managing agents of wholly aligned syndicates for tax purposes. However, regard may need to be had to the fact that a managing agent of a spread syndicate may have greater administration costs in reporting to all of the members participating on the syndicate; and may also have to deal with a greater risk of litigation or inadequate capital than a managing agent of a wholly aligned syndicate. These factors might lead to a conclusion that the wholly aligned syndicate may in some circumstances receive less overall remuneration than the managing agent of a spread syndicate. If, in such circumstances, the remuneration charged by managing agents of spread syndicates does not provide a CUP for the remuneration charged by the managing agent of a wholly aligned syndicate, another transfer pricing methodology such as cost plus would need to be applied.
- 4.3.4 It is important when comparing the profit commission and fees charged by the managing agent of a wholly aligned syndicate to that of a spread syndicate to have regard to the total remuneration of the managing agent rather than viewing the charges as distinct and separate. This is because the Agency Byelaw and standard agreement do not prescribe how a managing agent should be remunerated and some managing agents charge only fees and no profit commission; some charge profit commission and no fees; and some charge both. It should also be noted that where profit commission but no fee is charged the rate at which profit commission is charged may be higher, as

there will be uncertainty over what level of commission, if any, will arise whereas fees are usually based on the members' premium limits which are known at the beginning of the year of account.

- 4.3.5 Some managing agents charge a one-stop fee which covers fees, profit commission and expenses. Again the whole fee needs to be considered when deciding whether any adjustment is required under transfer pricing principles. The key factor will be the overall level of remuneration earned by the managing agent and not the labels given to the amounts paid.
- 4.3.6 Expenses are charged to members without any mark up being applied, because any profit made by the managing agent is made by charging profit commission or fees.
- 4.3.7 Expenses should not be looked at as a stand alone item or in isolation, but instead regard should be had to all of the charges made by the managing agent in deciding whether any transfer pricing adjustment is required. Expenses should require no mark up as the managing agent is merely charging on expenses that it has incurred, and under the managing agent's agreement only necessary and reasonable expenses can be charged to the members.
- 4.3.8 It should also be noted that, to the extent a CUP is available, one set percentage is not going to be adequate as a CUP. Provided that the fees and profit commission charged to aligned members by the managing agent are within a reasonable range they should be accepted. When comparing the fees and commissions charged to members of different syndicates, regard needs to be had to the fact that the level of remuneration derived by the managing agent will change depending on the types of business written by the syndicate and other factors, and also that it is possible for a managing agent to charge fees or profit commission or both

## **5. Service Companies (not including coverholders/ brokers)**

### **5.1 Legal**

- 5.1.1 Some groups set up service companies which perform some of the functions normally performed by the managing agents. For instance, some groups have separate service companies which employ the staff. They may employ only the staff of the managing agent or they may employ all of the staff in the group, including those providing services to non Lloyd's entities. In either case the shares will be owned by, and control will be exercised by, the same person who owns the shares of and exercises control over the managing agent. The costs of the service company (or a proportion of them where they are providing services to the whole group) will be charged to the members of the syndicate usually via a charge made to the managing agent which is then passed on to the syndicate.

5.1.2 There are two ways that this arrangement could operate, depending on who owns the service company. In some cases the service company is regarded as belonging to the members participating on the syndicate and therefore is an asset of their Premiums Trust Funds (“PTF”) because the funds to set up the company were provided by the members via the PTF. In this case the shares of the service company will still not be owned by the members, but will be owned by the group (of which the managing agent is also a member). In other cases, especially where the service company is providing services to non-Lloyd’s vehicles as well, the service company set up costs were funded by the group and are therefore not regarded as an asset of the PTF. In either case the shares will be owned by, and control exercised by, the same person who owns the share in, and exercises control over, the managing agent.

5.1.2 The Accounting Byelaw and the COP specify that expenses charged to members must be necessary and reasonable and allocated equitably between the members of the syndicate. Therefore aligned and unaligned members of the same syndicate would be charged expenses on the same basis.

## 5.2 Processes

5.2.1 There would normally be no profit mark-up on these expenses as no provision is made for profits on expenses in the standard agreement.

5.2.2 Some service companies were set up with a condition imposed by Lloyd’s that they may not make a profit. However, Lloyd’s no longer imposes this condition as there is no reason for a service company to be prevented from making a profit. The managing agent is required to disclose to the member details of any profit earned by the service company.

## 5.3 Transfer Pricing Approach

5.3.1 As explained above, in some cases the service company may be regarded as an asset of the PTF as the set up costs were funded from the PTF.

5.3.2 In either case, the managing agent’s group (as opposed to the member) would still exercise control over the service company (making the managing agent and the service company connected within Sch 28AA) and so any transfer pricing adjustment would be on transactions between the managing agent and the service company, and it is these transactions which should be at arm’s length prices.

5.3.3 If a service company of this type is set up, it must be providing services that would otherwise be provided by the managing agent. Members participating on the particular syndicate concerned would not expect to pay more fees, profit commission and/or expenses for this service than they would pay if no service company existed. Therefore, provided that the prices applied between the members and the managing agent for transfer pricing purposes are the same regardless of whether some services are being provided by a service company, any transfer pricing adjustment required to ensure that the service company is remunerated on an arm’s length basis should be made on

transactions between the service company and the managing agent, with no adjustment being required to the tax return of any member (whether the syndicate is wholly aligned or spread). This is in line with the principle that the managing agent is only able to charge to the members actual expenses incurred.

- 5.3.4 To put this another way, where a service company has been set up, it might be expected that some of the remuneration earned by the managing agents from payments made by the members will be recognised within the service company as remuneration for services that the service company performs instead of the managing agent. Therefore the profit of the managing agent in such a situation may be expected to be lower than in a managing agent where there is no service company.
- 5.3.5 An appropriate pricing policy may be cost plus for such a service company. However it is not appropriate to mark up all of the costs, and only certain operational costs (such as the cost of the senior management function) of the service company should be subject to this mark up. A compensating adjustment should be made in the managing agent's tax return.

## **6. Service companies which act as a Lloyd's coverholder**

### **6.1 Legal**

- 6.1.1 The Delegated Underwriting Byelaw ("Delegated Underwriting Byelaw") (No. 1 of 2004) allows a managing agent to delegate its authority to enter into contracts of insurance to an approved coverholder or a restricted coverholder under a registered binding authority or a restricted binding authority. The binding authority is the document which sets out the terms of the coverholder's delegated authority.
- 6.1.2 The Franchise Board maintains a register of approved coverholders, restricted coverholders and registered binding authorities. In order to become an approved coverholder an application needs to be made to the Franchise Board, via Admissions. The Franchise Board may at any time give directions to, or impose conditions or requirements on, an approved coverholder as it thinks "necessary or appropriate". The Franchise Board can also conduct a review of the approval at any time and has the power to revoke the approval.
- 6.1.3 The Franchise Board may impose a condition on a coverholder to ensure that it only acts in that capacity in accordance with a binding authority<sup>5</sup>. The Franchise Board also has the power to prescribe conditions and requirements with which all binding authorities or any class of binding authority must comply<sup>6</sup>. An approved coverholder may not enter into a contract of insurance under a binding authority until that binding authority is registered with Lloyd's.

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<sup>5</sup> Paragraph 16

<sup>6</sup> Paragraph 30

## 6.2 Process

6.1.2 Lloyd's Coverholder Handbook explains that Lloyd's supervises coverholders as part of its statutory role in managing and supervising the market. This is carried out through the approval process and ongoing supervision, both of which are the responsibility of Admissions. However, no reference is made to the commission or fees charged by the coverholder, as the Franchise Board is mainly concerned with ensuring that coverholders are competent and well run.

6.2.2 Admissions do not currently impose any condition on the profit which can be made by coverholders within a managing agent's group, although in the past some such conditions were imposed upon approval of the coverholder. There may therefore be some coverholders in the market that are operated without making a profit. There may also need to be additional controls over coverholders which are in the same group as a managing agent in order to protect the solvency position. Therefore, Lloyd's approval is required in order to set up a coverholder and Admissions require details of any remuneration from the syndicate to the coverholder and confirmation that this remuneration is on an arm's length basis on normal commercial terms.

## 6.3 Transfer Pricing Approach

6.3.1 Again, as above, the service company is sometimes regarded as an asset of the syndicate PTF depending on how it was set up in the first place. However, as explained in section 5 above, this should not make any difference to the transfer pricing analysis, as the coverholder will be controlled for the purposes of Sch 28AA by the managing agent (or the same person who controls the managing agent) not by the members of the syndicate.

6.3.2 Where the syndicate has spread capacity, the controls around the managing agent's duties to treat all members of the syndicate equitably and only to charge on fair and reasonable costs should ensure that the charges being made to the syndicate members are on an arm's length basis, including the charges made to any aligned members participating on the syndicate. Therefore no adjustment should be required under transfer pricing principles.

6.3.3 Where the syndicate is wholly aligned, the coverholder may be able to demonstrate that the pricing is on an arm's length basis by using comparable uncontrolled prices, for instance with reference to standard commissions earned on the same type of business.

6.3.4 In the case of a group coverholder, the transfer pricing adjustment is likely to be between the member and the coverholder (as part of the determination of the member's syndicate result), rather than between the managing agent and the coverholder. This is because, unlike the employer service company analysed at section 5 above, the coverholder is providing a service in addition to those provided by the managing agent and therefore it does not result in an adjustment to the managing agent's remuneration.

## **7. Brokerage Fees charged by a group insurance broker.**

### **7.1 Legal**

Lloyd's Act 1982 does not permit a person to act as a managing agent if that person is a Lloyd's broker or is associated with a Lloyd's broker.

### **7.2 Process**

7.2.1 There have been instances where a Lloyd's broker and a managing agent appear, at first sight, to be in the same group. However, approval will only be given to the managing agent if the chain of ownership is broken and this must be sufficiently robust to withstand legal scrutiny.

### **7.3 Transfer Pricing Approach**

7.3.1 As the chain of ownership needs to be broken in order for approval to be given, there may only be limited circumstances where a Lloyd's broker is connected for transfer pricing purposes to a managing agent. Therefore in all but exceptional cases no adjustment to the pricing should be required in relation to commissions paid to a Lloyd's brokers by syndicates. If there is an instance where a Lloyd's broker is connected to a managing agent under Sch 28AA (even though Lloyd's regards the chain of ownership to be broken for its purposes) such a case would need to be considered in the light of the same principles outlined elsewhere in this document. That is, a spread syndicate should provide its own CUP, while in other cases CUPs may be taken from market practice.

## **8. Reinsurance to Close**

### **8.1 Legal**

8.1.1 The Managing Agent's Agreement gives the managing agent the authority to act on behalf of the members of both the ceding syndicate and the assuming syndicate (assuming that both are under its management) to effect a contract of reinsurance enabling the ceding syndicate year of account to close. In doing so the managing agent is bound by its fiduciary duty to act in the interests of the member and to maintain equity between the members of the syndicate and between years of account. If the ceding and assuming syndicate are managed by different managing agents then any RITC would be an arm's length transaction, provided that the members of the syndicates are not connected.

### **8.2 Process**

8.2.1 An RITC on a wholly aligned syndicate will be equal to the closing reserves of the ceding syndicate, and these will have been subject to actuarial review. If the syndicate has a single member then the RITC is not a transaction between two entities (even though it is an RITC for Lloyd's purposes). Where

there is more than one group member participating on a wholly aligned syndicate there is a transaction between connected parties, but the managing agent would still have regard to equity between the members especially as participations could change from year to year.

### 8.3 Transfer Pricing Approach

- 8.3.1 Where a spread syndicate has reinsured to close into either a spread or an aligned syndicate year of account, there should be no adjustment of the RITC which is struck by the managing agent, as this is a commercial transaction between unconnected parties.
- 8.3.2 An RITC on a single member syndicate is not a transaction for the purposes of the transfer pricing legislation. On a wholly aligned multi-member syndicate there is a transaction, but the duties of the managing agent should ensure that the pricing of the RITC meets the arm's length criterion.
- 8.3.3 For the above reasons there should be no transfer pricing adjustments in relation to an RITC premium. It should also be noted that the discounting provisions introduced by FA 2000 will apply to the amount of the RITC, including cases where the RITC is between connected companies (see Regulation 7(9) and 7(10) SI 2001/ 1757), to apply the discounting back to the date that liabilities were first assumed by the group.

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