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CLIENT ALERT

# UK ILS Regime: Government Launches Consultation on Securitisation Structures Including Stamp Duty on ILS

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The UK Government has recently launched a consultation regarding the taxation of securitisation companies, including certain tax aspects of insurance special purpose vehicles (**ISPVs**). The reasoning behind the latest consultation according to HM Treasury is that the UK 'government is keen to ensure the UK's tax code keeps pace with the evolving nature of the capital markets, and contributes to maintaining the UK's position as a leading financial services centre.'

This is particularly welcome now, following Lloyd's move in January 2021 to back the UK ILS market by sponsoring an independently owned and managed UK protected cell company, London Bridge Risk PCC.

***Background***

HM Treasury signaled its intention to explore implementing an insurance-linked securities (**ILS**) regime in the UK in the March 2015 Budget. A consultation process was undertaken over 2016 and 2017 by HM Treasury, the Prudential Regulation Authority and the Financial Conduct Authority and Willkie responded to each of the papers.

Legislation was enacted in 2017 in the form of The Risk Transformation Regulations 2017 (which introduced a new corporate structure for multi-arrangement ISPVs (**mISPVs**), namely protected cell companies) and The Risk Transformation (Tax) Regulations 2017 (which set out the UK tax treatment of 'insurance risk transformation' and associated distributions to investors).

***The Risk Transformation (Tax) Regulations 2017* (2017 Tax Regulations)**

Following the 2016 consultations, HM Revenue & Customs took a straightforward approach of exempting from corporation tax the insurance risk transformation profits of ISPVs and mISPVs. This was a welcome change from the relatively more complex approach that had been taken in predecessor regulations in 2007 (which, broadly speaking, relied on allowing ISPVs to calculate their corporation tax profits in line with 2006 accounting practices).

However, the 2016 consultations and the 2017 Tax Regulations focused only on eliminating tax leakage at the level of the ISPV or mISPV and ensuring that distributions to investors (either by way of dividends or interest) would not be subject to UK withholding tax.

The uptake for the UK ILS regime has been relatively modest so far with established jurisdictions such as Bermuda, Guernsey and Ireland maintaining a competitive edge. Despite London's position as the largest global hub for insurance risk, it has not so far been able to draw a substantial part of the global ILS market to UK shores. However, the tide may begin to turn in 2021 with Lloyd's move to back the UK ILS regime by establishing London Bridge Risk PCC. This development is an exciting opportunity for new investors to access the Lloyd's market using a prebaked and largely tax exempt onshore vehicle.

***Reform of taxation of securitisation companies***

On 23 March 2021, HM Treasury and HM Revenue & Customs published a further consultation paper which includes within its scope the stamp duty aspects of the UK ILS regime (the **Consultation**).

As described above, the 2017 Tax Regulations endeavored to eliminate tax leakage at the level of the ISPVs or mISPVs themselves, but did not address the stamp duty implications of transferring the securities issued by such vehicles. This could potentially result in investor-level costs that would not usually be a concern in respect of an equivalent Bermuda or Guernsey investment. HM Revenue & Customs notes in the Consultation that there is 'uncertainty' as to whether debt instruments issued by UK incorporated securitization vehicles (including ISPVs and mISPVs) would be subject to stamp duty or whether the UK's exemption for loan capital applies.

In fact, in the context of ILS, most cautious UK tax advisers would have serious concerns that such instruments are potentially within the scope of UK stamp duty. This is because the loan capital exemption is subject to three exclusions where the instrument carries or has carried (in summary):

a) a right to interest which exceeds a reasonable commercial return;

b) a right to interest which is determined by reference to the profits of a business or the value of any property; or

c) a right to repayment which exceeds the nominal amount of the capital and is not reasonably comparable with what is generally repayable under the terms of loan capital listed on the London Stock Exchange.

In principle, any of these provisions may be read as potentially applying to an ILS, thereby excluding it from the loan capital exemption (and subjecting it to stamp duty).

This is because participating ILS carry a right to interest which is calculated by reference to the results on the underlying reinsurance book, thereby failing condition (b) above. Non-participating ILS such as catastrophe bonds carry more straightforward interest rates, but as non-correlated investment assets, those interest rates may be substantial (potentially in excess of 15%) compared with other debt instruments listed on the London Stock Exchange (thereby potentially failing both conditions (a) and (c) above).

In order to ensure that the UK's ILS regime competes with more established jurisdictions, HM Treasury is right to address the stamp duty aspects of such structures. While the Consultation does not expressly mention exempting shares as well as debt instruments issued by an ISPV or mISPV, we cannot see a convincing policy reason to exempt one class of instrument and not the other. The reasons for choosing to issue preference shares over notes is a commercial one, with the economic characteristics of each broadly the same. Providing a stamp duty exemption for ILS that are notes but not shares would inexcusably limit the attractiveness of the UK ILS regime. Therefore, a clearly legislated stamp duty exemption for both debt instruments and preference shares issued out of an ISPV or mISPV would be a welcome simplification of UK ILS structures.

***Expected effect of legislative change***

HM Treasury notes in the Consultation that the usual workaround for instruments issued by securitisation vehicles (including ISPVs and mISPVs) that may not qualify for the loan capital exemption is for the securities to be issued directly into a depositary receipt system or clearance service. This should prevent UK stamp duty from becoming payable in respect of the securities in most circumstances. Such services are frequently used in respect of instruments that are intended to be traded, irrespective of whether the vehicle itself is established in the UK or offshore. As such, for debt instruments that are intended to be traded from the outset, there is a ready-made solution.

However, a clearly legislated stamp duty exemption would still be welcome because it should be considerably simpler to explain both to potential issuers and to investors. It would remove one small barrier that may put an issuer off choosing the UK as the jurisdiction in which to establish its investment vehicle. While there is not excessive liquidity in ILS currently, this is improving and is a key focus of many new investors in the ILS market and therefore duties on transfer are increasingly becoming a consideration for investors. In addition, even where securities are not intended to be traded between third parties, it is not unusual for them to be transferred from one investment fund to another with a longer lifespan and under common control. Stamp duty relief on such transfers may not always be available and where it is, it is administratively burdensome.

Lloyd's recent creation of London Bridge Risk PCC has brought renewed interest in the UK's ILS regime and puts the 2017 Tax Regulations under increased interest from overseas investors looking for a tax neutral structure. A priority of the UK ILS regime must be to ensure that it has a wide-ranging application to ensure it attracts as much new investment to the UK insurance market as possible. Open ended structures will therefore need to consider how they can bring investors in and out while minimizing UK tax leakage. They may consider transferring the underlying contracts for Funds at Lloyd's between the cells of an mISPV, thereby allowing the investor base to change. However, such a solution is cumbersome and a regulatory analysis would need to be undertaken. It would be preferable for the shares to change hands without stamp duty becoming payable.

Finally, while the uptake for the UK ILS regime has not been overwhelming so far, we anticipate a continuing push over the next five to 10 years towards onshore structures. The OECD's on-going Base Erosion and Profit Shifting project continues to move against offshore and low/no tax jurisdictions. We are currently waiting to hear about the outcome of its Pillar 2 project recommendations. The legislative change which the OECD initiates gradually causes perceptions to shift across investment markets. In that context, the UK government's continued focus on designing a competitive ILS regime is very encouraging.

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