DIRECTORS AND OFFICERS LIABILITY INSURANCE - THE TAX IMPLICATIONS

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Directors and officers liability insurance ('D & O') is increasingly effected by directors and their companies. The nature of the cover itself itself is quite well understood but not so the various taxation aspects which arise. This article outlines the tax implications which will need to be considered by the parties to the insurance.

This is not the place for a detailed exposition on the legal liabilities of the director or other officer (hereinafter 'director') or the structure of D & O cover. Suffice it to say that D & O indemnifies a person for most damages arising from personal legal liability incurred by him *qua* director, together with the associated costs of defence or other representation. Cover is usually arranged on a 'board' basis (for all directors in a given company and group) and also provides reimbursement to the company itself to the extent that the director has been able to obtain his indemnity from his company.

The restrictions in relief from liability and in enforceable indemnity contained in *Companies Act 1985, Sections 310 and 727* are well known and are particularly relevant. The amendment to Section 310 introduced by *Companies Act 1989, Section 137* did not alter that situation but did have the welcome effect of 'legitimising' D & O by killing the argument that an insurance indemnity of this type was itself unenforceable. The author's article in BILA Journal No. 73 covered this developed in more detail.

The Premium

In common with other insurances, D & O premiums are exempt from VAT *[Value Added Tax Act 1983, Schedule 6, Group 2]*.

As has been indicated above, there are two parties to the insurance arranged on a 'board' basis: the directors collectively and the company. They are covered under separate but connected policies or, alternatively, under separate sections of a single policy. Either way, the premium must be apportioned and it is conventional for 90% to be allocated to company reimbursement cover, leaving 10% to be allocated between the various identifiable insured directors in some manner agreeable to them, not necessarily equally. Where cover is arranged on an 'individual' basis (protecting one man in respect of his various directorships) there is no company reimbursement cover and the whole premium falls on the director.

The company will not generally have difficulty in demonstrating that the total D & O premium it pays (including any relating to the directors' cover) has been laid out 'wholly and exclusively' for the purposes of the trade and is thus deductible from profits for corporation tax purposes *[Income & Corporation Taxes Act 1988 [ICTA], Section 74 [a]]*. One would not reasonably expect such expenditure to be challenged on the ground, if applicable, that the directors controlled the company and that its expenditure was at least partly for their own advantage, despite the decision in *Samuel Dracup & Sons Ltd v Dakin [1957] 37 TC 377* which held that company-funded controlling directors' pension contributions were not an allowable deduction. It is the tax treatment of the premium attributable to the director that causes a problem for the director.

The Director

The office and duties of a director are distinct from those imposed upon the same person under a contract of service with the company. A director does not have to be also an employee but very often is and may carry out an act in both capacities simultaneously, as in *Lee v Lee's Air Farming Ltd [1961] AC 12*. Some directors, usually non-executive, will be practising professionals or consultants whose services are provided by their own company or firm, which will receive that relevant director's fees to the exclusion of the office holder himself. A director in this situation will not be an employee of the first company but may be an employee of or a self-employed principal in the professional practice.

Certain individuals, usually employees, may act as *de facto* (constructive) directors. The directors may themselves be under the influence of a shadow director. D & O will usually insure such persons *qua* director; certainly so if cover is arranged on a 'blanket' basis to embrace all who are (or are deemed by the court to be) directors or officers. If a body corporate is a director, it will not *ipsofacto* be denied cover.

An officer other than director may be less easy to recognise - indeed, he may not himself appreciate his true situation - but will be generally in a similar position to that of the director in relation to the company. The most obvious distinction concerns those office holders (i.e. auditor, liquidator, administrator, administrative receiver, solicitor) who are not 'management' nor employees, nor are they insured by D & O.

The premium paid by or attributable to the director is most unlikely to be deductible from the emoluments of his office or employment assessable under Schedule E. The expenses will not satisfy the well-known test *[ICTA, Section 198 [1]]* of being incurred 'wholly, exclusively and *necessarily* in the performance of those duties' attaching to the office or employment. This will be so even if the director is 'required' by his company to be insured; it is the nature of the duties of the *job* alone which can *necessitate* the expenditure; *[Brown v Bullock [1961] 40 tc 1]*.

Where the director's own premium is paid in whole or part by his company, and not reimbursed by him, it will constitute a taxable benefit to him *[ICTA, Section 154]* unless, exceptionally, the test set out in the previous paragraph is satisfied. Under present legislation there would not appear to be any liability to national insurance contributions (to employer or employee) on the premium. It follows that there is an overall saving if the director's premium is paid by the company, rather than by him out of additional salary which, after deduction of tax and any NIC, is equivalent to that premium.

The premium paid by or on behalf of the practising professional will usually attract relief under *Schedule D, Case II* when, as suggested above, the director's fees belong to the practice and the premium expense is 'wholly and exclusively' incurred by the practice. Fees are usually assessed on this basis even though [per *IRC v Brander and Cruickshank [1971] 46 TC 574]* they strictly would be within *Schedule E*.

Loss and Indemnity

The director's personal liability for loss falling on him *qua* director will not be tax deductible against his emoluments; even though part or all of that loss is a legal liability it is not 'necessarily' incurred, even under compulsion by the company or a co-director, or where clearly in the *bona fide* interests of the company.

If the company itself provides a partial or full indemnity (where or not it is obliged to do so and regardless of any D & O cover available to it), that indemnity meets a pecuniary liability of the director and is potentially subject to income tax, e.g. under *ICTA, Section 153* as an expenses payment. If the indemnity is provided directly by the insurer under the D & O cover, it may be on that basis that the director meets the losses personally and then receives reimbursement (i.e. 'pay to be paid'), or that the insurer stands in the director's shoes and meets his obligations *ab initio*. In either case, the indemnity may again be treated as a taxable emolument, although the position is not entirely clear. The rule seems to be that the director's receipt of indemnity from the company will be taxable in that hands of that director unless the company was acting as payment agent only on behalf of an insurer whose premium has (at least in part) been met by or taxed on the director in question. If indemnity is provided by some other third party, it is suggested that the situation would be the same.

Whilst taxation is often neither fair not logical, it is understood that the Revenue view accords with simple commonsense in that it would not seek to tax an insurance indemnity where the premium has been met by, or taxed on, the indemnitee. This follows the practice in relation to medical expenses and personal accident insurances. Moreover it would be harsh to tax the indemnity yet allow no deduction for the corresponding loss covered by that indemnity - there is clearly no 'profit or gain', a fact that already precludes liability under *Schedule D, Case VI.* Capital gains tax liability does not arise.

As far as the company is concerned, the position is straightforward. Just as premiums are deductible from profits, so should be indemnities to directors, whether enforceable against the company or provided *ex gratia*. Reimbursement received from the insurer will be a taxable receipt. Again there is no overall profit and the imposition of an excess will often result in a net loss.

Where a loss includes VAT and the person entitled to indemnity is VAT-registered, the insurer will look to that person to recover the input tax himself in the usual way and will limit the indemnity to the loss net of such recoverable VAT. The director will not normally be in position to recover input tax; losses borne by him and indemnities provided to him will normally be VAT-inclusive and hence potentially greater for income tax purposes.

The Future

There is a strong argument that the prudent and competent director needs the safety net of D & O just as much as the person for whom the cover might more obviously be a rogue's charter. Nowadays, it is rare in the USA for a director to take up office unless and until he is satisfied that D & O is in place; there is some evidence of a similar trend in the UK. The D & O premium may never fully satisfy the notoriously stringent test of being 'necessarily incurred but most directors, and their companies, would consider it a commerical necessity.

The probable tax charge to the director indemnified by his company (rather than by insurance) reinforces this view. Insurers do not like their potential for provision of indemnity to be advertised, nor do directors want to encourage litigants to target them. Nevertheless, it can be said to be in the public interest for the successful plaintiff to have a chance of enforcing as well as proving his claim. It may be for this reason that *Companies Act 1985 Schedule 7, Part I, paragraph 5A* now requires bare disclosure of the purchase of D & O in the company's directors' report.

It is possible that the Revenue will be persuaded to change the law or at least to recognise an extra-statutory concession allowing relief for D & O premiums attributable to the director. At the same time, the residual uncertainty regarding the tax treatment of losses and the corresponding receipt of indemnity should be removed. In particular, the non-taxing of indemnity should not be dependent on the absence of either insurance or of relief of premiums.

The Association of British Insurers and the CBI both called for clarification of the law on the above lines in their annual representations to the Chancellor ahead of the 1991 Budget. The ABI and a number of other bodies are making more detailed representations to the Inland Revenue, Initial response has not been particularly encouraging and time will tell whether any success is ultimately achieved. The author participated in the deliberations at the ABI and this article draws in part on the underlying information; the views expressed are, however, the author's own.

BANK OF NOVA SCOTIA -V-
HELLENIC MUTUAL LIMITED
"GOOD LUCK"

by James Thomas
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The House of Lord's decision in *"Good Luck"* is one of which all marine insurers would be well advised to take note, affecting as it does the very core of their relationship to mortgagee bankers.

As readers will recall, the Court of Appeal had held that the effect of breach by an insured party of a promissory warranty in a contract of marine insurance was not automatically to discharge the insurer from liability but, rather, to place him in the position of having an option to avoid the contract. The House of Lords now stands this decision on its head having held that, in accordance with the rule of marine insurance, compliance with a promissory warranty is a condition precedent to the acceptance of risk by an insurer and his consequent liability. Section 33(3) of the Marine Insurance Act 1906 on its true construction provides that, in the event of a breach by an insured party of a promissory warranty in a contract of marine insurance, the insurer is automatically discharged from liability as from the date of the breach unless an express term of the policy provides otherwise or the insurer waives the breach under Section 34(3). At the same time, the House of Lords held that this automatic discharge from liability did not have the effect of automatically bringing the contract to an end.