Global tax points for insurers

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Building a better
working world

Foreword

Welcome to our third edition of *Global tax points for insurers*, an informal series that provides insurance executives with a snapshot of some interesting developments in the ever-changing world of tax around the globe.

In this issue, we explore a number of tax developments for insurance companies, beginning with a discussion of the Base Erosion and Profit Shifting (BEPS) project by the Organisation for Economic Co-operation and Development (OECD). The OECD published its final reports last October, and we are now seeing concerted efforts by governments around the world to implement its recommendations. But some matters were held over by the OECD for further work in 2016 and 2017. Among these is a consideration of risk transfers between related parties, particularly in the context of captive insurers. Our first article explores the potential impact of this work. In keeping with the reinsurance theme, we review the position in Canada, where recent years have seen an increase in offshore-related party risk transfers.

Our focus then shifts to the tax landscape for insurers in Singapore, which continues to grow as a global financial center — particularly for insurance. The Singapore Government has responded quickly to the main BEPS recommendations. It has overhauled its incentive regime so that it continues to provide an attractive environment to hub insurance business in the region as part of a tax regime in line with international leading practice.

Finally, we look at insurance premium taxes. For many years the "forgotten tax," premium taxes are beginning to attract attention as rates move up and multinational policyholders are focusing on their obligations and exposures.

We hope these articles will help you navigate the evolving tax environment, and we look forward to sharing our tax insights with you through this series.

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BEPS Action 4 focuses on taxation of captive insurance companies

Three years after the G20 countries launched the OECD BEPS project and six months after the G20 finance ministers gave their stamp of approval to 15 BEPS final reports in late 2015, the OECD commenced work on a new paradigm to align greater predictability, consistency and even alignment with tax authorities and wider government agencies worldwide. The initial premise was that existing international tax norms are inadequate to protect the corporate tax bases of countries where multinational corporations earn income and add value.

The OECD developed reports within the two-year deadline created by the G20 countries, and many of these proposals are now being implemented. The 15 BEPS final reports include model legislation, revising OECD transfer pricing guidelines, new rules relating to the definition of permanent establishment, and new anti-tax treaty and transparency measures. Included within one of the action items is a focus on captive insurance arrangements within non-insurance groups, which is a specific target of this new project relating to financial transactions.

Action 4 of the BEPS final report addressed limiting base erosion that takes place via interest deductions, other financial payments and transfer pricing rules relating to financial transactions, which include captive and other insurance arrangements. The Action 4 final report, however, focused strictly on interest deductibility, leaving the other matters described above to a new project that will be undertaken during the remaining months of 2016 and 2017.

In discussions with the OECD, the work has been described as focusing in part on:

- Premium payments to captive insurance companies within non-insurance groups
- The extent to which such captive arrangements actually are insurance arrangements and involve the shifting and distribution of risk
- The pricing of these payments and how that pricing takes into account group synergies
- The extent to which captive insurance entities are subject to regulation and the nature of that regulation
- Other similar issues

It is clear that the business and regulation of captive insurance may not be fully understood by OECD staff and the representatives from government tax authorities making up the working party addressing this issue. It also is clear that the OECD secretariat is the key facilitator of this project, spurred on by indications from many countries' tax authorities believing captive insurance arrangements within non-insurance groups may not be economic and therefore involve a worrisome BEPS activity.

Given the likelihood that the OECD's BEPS project team will be writing new transfer pricing guidelines relating to captive insurance, it is important for the industry to undertake a thoughtful and coordinated effort to work with policymakers to develop principled rules to accommodate current industry practice and regulation, so as to help prevent dislocation of those practices and business models. Without industry input and education, there is a danger that the project could have a significant impact on the use of captives within non-insurance groups.

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Recent trends in offshore reinsurance

In Canada, there is a growing trend among foreign insurers to cede their Canadian risks offshore to their related group to limit capital retention. The elimination of restrictions has caused an increase in unlicensed offshore reinsurance. Foreign insurers are using related-party offshore reinsurance to increase policy maximums without providing corresponding capital. This strategy is being questioned by the regulators and has the potential to increase policyholder risk.

Multinational insurers participating in offshore reinsurance strategies should be mindful of this increased scrutiny by Canadian regulators and exercise care when planning and executing such transactions. Reinsurance is understandably an important risk management tool for insurers, as it may reduce insurance risks, temper volatility of financial results, stabilize solvency, help withstand catastrophic events, increase underwriting capacity and make more efficient use of capital.

In 2010, unlicensed reinsurance (unregistered reinsurance) rules were relaxed. Canadian insurers no longer are required to limit the aggregate of reinsurance with unregistered offshore related parties to a maximum of 25%. This limit was repealed and replaced by Office of the Superintendent of Financial Institutions (OSFI) Guideline B-3, which provides a framework for reinsurance governance that insurers are expected to adhere to as part of their overall risk management. Following the elimination of the 25% limit, regulators were concerned about insurers abusing the relaxed limits by ceding their Canadian risk offshore — essentially increasing policy limits and sizes without changing net risk retention. This strategy introduces a concentrated credit risk to policyholders and raises prudential concerns given the possibility of distress in the unregistered reinsurer, whether affiliated or not.

Critical tax issues that arise include value-added tax (VAT), indirect taxes, excise tax, transfer pricing and general deductibility of premiums, as well as Canadian foreign affiliate rules.

The Canadian Revenue Agency (CRA) is reviewing reinsurance transactions with more scrutiny through a transfer pricing lens. First, the CRA is reviewing the relevant accounting standards to measure the fair value of the risk ceded to a foreign-related party. Second, the CRA is questioning the comparables used in transfer pricing reports to estimate the fair value of ceded premiums and liabilities. It is no surprise that portraying a transaction under reinsurance accounting is important to understanding the transaction, yet Canadian courts clearly view it from a legal perspective, i.e., as a contract between the parties. Nevertheless, where Canadian insurers cede premiums and liabilities to a foreign related party and value those premiums and liabilities using accounting standards differing from International Financial Reporting Standards, the CRA has questioned the accuracy of the fair value of the amount ceded. In addition, upon reviewing such transactions, the CRA has questioned the validity of arm's-length pricing for intercompany reinsurance transactions.

For the purposes of VAT, reinsurance and insurance are generally exempt services. However, the financial regulators have legislated a special rule applicable to related party offshore reinsurance. Under these rules, the Canadian ceding company when ceding business to a related offshore insurer must estimate the expense loading in the contract of reinsurance by the reinsurer. This would require the ceding company to get information from the reinsurer about the arm's-length price it has charged in the reinsurance contract. This requirement has left this sector of the insurance industry in turmoil, as no reinsurer actually charges its expenses to the ceding company. Failure to identify and quantify these expenses could cause the ceding company to pay GST on the entire reinsurance premium ceded. Recent updates on this topic have been favorable news to the industry in that finance has issued comfort letters providing a more realistic formula to compute the expenses subject to GST.

Given OSFI and the CRA's recent scrutiny in this area, when undertaking a related party reinsurance transaction, parties should analyze more closely the tax implications of such transactions.

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Singapore as a regional hub for insurers

Singapore is one of the world's largest financial centers; its insurance, reinsurance, captive and brokerage markets are a key part of its success. By the next generation, two-thirds of the world's population are estimated to live in Asia and comprise a rapidly growing middle-class with greater disposable income. Combined with infrastructure spending, this is expected to drive an increasing demand for insuring various risks.

Singapore is a desirable choice for multinational insurance groups looking to relocate their regional carrier or holding company to an Asian jurisdiction, with potential market opportunities and proximity to local regulators, customers and management.

Since the late 1970s, Singapore has added attractive tax incentives to reduce the effective tax rate on certain insurance and reinsurance profits relating to "offshore" risks (subsequently expanded to incentives for brokerage and captives). As the Singapore insurance industry matures, a post-BEPS world demands that business functions support tax transparency and taxable profits. Singapore Budget 2016[1] was the perfect opportunity for Singapore to assess its tax system so it stands up to international scrutiny while remaining one of the most competitive regimes in the Asia-Pacific region.

Various tax incentives were extended for certain risks deemed vital for Singapore's insurance industry (e.g., marine hull and liability (MHL)), and specialized risks were consolidated into a new Insurance Business Development (IBD) scheme. Under this umbrella, the 10% concessionary tax rate remains for approved insurers on qualifying income derived from underwriting offshore risks. The concessionary tax rate will be 5% for newly awarded tax incentives before 21 August 2019 and 8% thereafter, and 10% for existing approved insurers that renew. The concessionary tax rate for MHL insurance, currently exempt or 5%, will increase to 10%.

Following scrutiny by the OECD in BEPS (Singapore is a BEPS Associate country), Singapore also removed the tax exemption for offshore captive insurance companies by introducing a 10% tax rate. Current approved insurers will continue to enjoy benefits under existing awards until their expiration and may apply for renewal under the IBD scheme thereafter. Singapore will continue to ensure that its incentives are underpinned by qualitative and quantitative substance requirements. Accordingly, for most insurance and reinsurance players, the IBD regime will remain attractive.

For insurance multinationals seeking to place holding companies in their global group structure, it is worth exploring the Finance and Treasury Centre (FTC) scheme, which is subject to substance-based requirements. The exemption from withholding tax on interest payments is attractive. Budget 2016 extended this for another five years until 31 March 2021 with enhancements such as lowering the concessionary tax rate from 10% to 8% (keeping it below Hong Kong's tax rate of 8.25%, which has been lowered for qualifying income derived by corporate treasury centers). In addition to the incentives noted above, a territorial system of taxation allows licensed Singapore insurers to operate in Asia-Pacific through a foreign branch network with branch profits exempt from Singapore tax.

The Inland Revenue Authority of Singapore (IRAS) practice, published in October 2015 in response to losing to the taxpayer in *CIT v BBO [2014] SGCA 10*, provides comfort for existing group structures. A licensed insurer may hold shares in subsidiaries on a tax-free capital gains (rather than taxable revenue) basis[2]. However, a separate holding company and insurance company structure is still more appropriate for new structures to reduce risk.

In summary, Singapore continues to be an attractive location from a tax perspective for global insurance groups to locate both their Asia-Pacific regional holding company and licensed insurance companies. Multinationals may wish to review their current structures in light of the attractiveness of the Singapore tax regime.

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[1] The Singapore budget is prepared by the Ministry of Finance annually beginning 1 April each year and ending 31 March the following year. The budget includes revised Government revenue and expenditure projections for the current financial year, as well as the planned Government revenue and expenditures for the coming financial year.

[2] Documentation requirements would need to be met by the insurers to qualify for such treatment.

Stepping out of its shadow: insurance premium tax

With a global trend for governments to shift from direct to indirect taxation, an increasing number of countries have introduced or increased insurance premium tax (IPT) and para-fiscal charges. As this "forgotten tax" steps out of the shadow, insurers must think differently if they are to understand the implications of IPT compliance.

In most jurisdictions around the world, insurance premiums are subject to indirect taxation, such as VAT, the consolidated Goods and Services Tax (GST) or a specific tax, usually IPT, stamp duty or other levies.

The variety of taxes on insurance premiums has become a burden for insurers writing global multi-jurisdictional programs, as they need to understand which taxes apply in countries where risks are located. This can be multiple when only one global premium needs to be apportioned appropriately. Different tax regimes and the admission status of insurers dictate if the policyholder or insurer bears the economic tax burden. This needs to be clear before binding the business. Once the tax has been collected, insurers must administer and pay taxes in those countries.

Mindful of these considerations, brokers are becoming more concerned about their liability and role in calculating taxes for insurers. There is also a stark trend among policyholders (i.e., large organizations with multinational risk exposure) to recognize their liability and responsibility for settling the tax in countries where insurers are not supervised by local regulators. Unwilling to bear the burden of noncompliance, policyholders increasingly demand evidence of correct tax settlement by insurers or initiate an in-depth review of their IPT global risks.

Recent trends highlight the importance of IPT

Increased IPT audits: Tax authorities are proactively tackling noncompliance of non-domestic insurers. Germany, for example, shifted from a loose network of local tax offices to a centralized IPT function at the Federal Central Tax Office. This aligns procedures for foreign insurers writing business in Germany and enforces targets for tax inspectors. The Netherlands doubled its IPT teams in recent years, whereas Belgium and Spain are working closely with regulators to identify noncompliant insurers. Tax inspectors auditing a company and finding a policy from a non-domestic insurer are passing information to relevant IPT authorities within their country and then issuing an assessment for the unpaid IPT. Frequently, this happens so that premium appointment can be reviewed to confirm that the country's statutory apportionment rules have been adopted.

Widening the scope of insurance: Various court cases apply to the scope of insurance and IPT application. A recent Dutch case clarified that activities of a company offering breakdown assistance for a fixed annual fee is an insurance contract and, therefore, subject to Dutch IPT. We see that the trend to broaden the scope of premium tax is increasing.

Increased rates: In 2015 alone, France, Malta, Portugal, Slovenia and Italy increased IPT rates. The biggest surprise for insurers and buyers was in the UK, where within a year, two increases combined, exceeding 50% of the rate from the beginning of the year.

Onerous reporting: We often see that systems cannot cope with IPT reporting requirements, as they do not capture relevant information to support the increasing number of tax filings.

Organizations should consider a review of their people, processes and technology, to confirm IPT compliance is in line with latest regulations at the local country level. Companies should be enabled to apply correct tax rates (e.g., by means of a global online premium tax database), capture the relevant reporting data in their systems and file periodic returns through a local agent, verifying compliance outside their home jurisdiction.

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