



Global tax risks bring increased challenges

Evolving Insurance Risk and Regulation

Preparing for the future - Chapter 6

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Introduction

It seems that every year industry experts say that the taxation of the insurance industry is going through unprecedented change. Whether the change is unprecedented can be debated, but there can be no doubt that change is accelerating in this digital age and presenting new tax risk management challenges. Insurance companies must not only manage the current tax risk, but anticipate legislative changes, tax audits, new financial disclosure requirements, reputational concerns, documentation, and data management risks.

Identifying tax risk and managing it is of increasing importance to all business professionals, including those outside the traditional tax function. The board, senior management, shareholders, customers, regulators and governing bodies are all trying to understand what an insurance group's tax risks are and how such risks are being managed. There is clearly an opportunity to improve coordination and collaboration among the various constituents of an organization with respect to defining, managing and communicating tax risk information.

With the backdrop of requirements for greater controls and disclosures, insurance companies face increasing challenges in managing their global tax risks and reporting requirements. The tax risks include failure to comply with tax laws, transactions generating unintended tax consequences, inaccurate financial reporting and related disclosures, and tax authorities changing their approach with increased risks for multiple taxation of items from various jurisdictions. Furthermore, with increased regulatory requirements, insurance companies need to accurately model their taxes under a variety of scenarios.

In response to these developments and to better understand a company's global tax position, the Organization for Economic Cooperation and Development (OECD) undertook a major study on Base Erosion and Profit Shifting (BEPS) designed to give taxing authorities the tools to combat inappropriate tax planning strategies and increase the transparency of groups' global tax affairs.

Base Erosion and Profit Shifting

The OECD Base Erosion and Profit Shifting (BEPS) reports¹ highlight many of the challenges that insurance companies face in managing their global taxes. The BEPS reports include actions on controlled foreign corporation rules, interest deductions, treaty benefits, permanent establishments, transfer pricing, and mandatory disclosures. Insurance companies are already having to comply with new requirements such as country by country reporting, diverted profits tax rules in the UK and interest deduction limitations in a variety of countries.

The BEPS reports particularly highlight the challenges presented by the digital economy, noting that both it and its business models present some key features that are potentially relevant from a tax perspective, these include mobility, reliance on data, network effects, the spread of multi-sided business models, a tendency toward monopoly or oligopoly, and volatility. These have some relevance to the insurance industry, but additional issues, such as capital risk, and their impact on profit allocations, create unique issues for the insurance industry.

The BEPS reports note that while the digital economy models do not generate unique BEPS issues, some of its features exacerbate risks. In this chapter we seek to explain some of these risks that present challenges for an insurance company conducting business in the digital age.

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¹ The BEPS project, launched in July 2013 culminated in the release of a package of reports in November 2015.



Permanent Establishment

Under pre-BEPS rules, an insurance company that did not have an office or other fixed place of business in a country was not considered to have a taxable presence in that country unless it had agents that concluded contracts there. Thus, a company could have agents selling insurance in a country as long as the insurance contracts were not concluded there. With the internet, it is not difficult to sell insurance in one country and submit the application to a company in another country for approval and issuance.

Now a company must consider if an agent “habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification”. This new standard is both broader and more subjective than the former standard, potentially increasing the number of tax jurisdictions in which taxpayers are potentially exposed to taxation.

Also a foreign insurance company can no longer rely on the independent agent exception to conclude that an agent’s activities do not give rise to a permanent establishment in the agent’s jurisdiction, where the agent acts exclusively or almost exclusively on behalf of one or more enterprises to which it is closely related. Under BEPS, an agent is considered to be closely related to the foreign insurance company on behalf of which it is acting if, based on the facts and circumstances, one has control of the other or both are under common control. In addition, a person will be considered to be closely related to an enterprise if they are under common ownership control of greater than 50 percent.

This narrowing of the independent agency exemption could create new permanent establishments for insurance companies. For example, a company reinsuring business from a related company in a different country will need to determine if the related company could be a dependent agent. The risk is that in certain circumstances merely reinsuring business from a foreign affiliate could give the reinsurer a new permanent establishment.

Transfer Pricing

Cross border insurance must appropriately allocate taxable profits between countries. Unfortunately, the determination of what is ‘appropriate’ is changing. BEPS includes revised guidelines intended to ensure that the allocation of taxable profits is based on the contribution that the individual companies make to a transaction.

Companies must look at the actual risks assumed, the functions performed and whether a transaction would be commercially rational if performed between unrelated companies. The BEPS reports include some helpful language regarding insurance business, but nonetheless brings new uncertainty to the appropriate transfer pricing of cross border insurance and reinsurance transactions.

Further guidance is expected on what arm’s length means for financial transactions, including reinsurance transactions.

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Country-by-country reporting

Beginning in 2017, insurance companies will be required to report by country where they have income and pay taxes and where they have employees. This has the potential of highlighting situations where a group has large amounts of income in countries with relatively few employees. BEPS transfer pricing focuses on where people are adding value. This may be quite different from how highly regulated and capital intensive businesses like insurance and reinsurance earn income. The insurance industry has made this point with the OECD, but the country-by-country (CBYC) reporting rules were not modified to reflect their concerns. This could create tax risk if countries change their approach to taxing insurance companies based upon key factors in the CBYC report such as location of their employees as opposed to the traditional approach of taxing insurance companies based upon location of the capital and insurance risk.

Another concern is that the regulatory requirements for where employees sit within a group may not conform with the BEPS view of where profits should be attributed.

Controlled foreign company

The BEPS reports note the risk that taxpayers with a controlling interest in a foreign subsidiary could reduce the tax base of their country of residence and, in some cases, other countries by shifting income into a controlled foreign company (CFC). The reports note three ways in which insurance income earned by a CFC could be a concern: CFCs that are overcapitalized, reinsurance assumed from a cedant outside the CFC's jurisdiction, and related party insurance income.





KPMG perspective

- The OECD BEPS project is one of the most significant developments in international tax in the last 50 years.
- The adverse publicity directed at taxpayers perceived to have been engaged in tax avoidance (for example, in connection with the release of the so-called Panama Papers) suggests that the trend to more complex and restrictive tax rules is likely to continue.
- The changes proposed as part of the BEPS project have been mirrored in local country legislation, such as the UK's diverted profits tax, the European Union's draft Anti-Tax Avoidance Package and the US's recent sweeping proposed regulations re-characterizing debt as equity in certain cases.
- The insurance industry is likely to find unique challenges in coping with the new global tax environment to be especially challenging, and insurance company boards, not just the Chief Financial Officers and global tax directors, may need to devote greater time to discussing tax issues than they have in the past. Failure to properly prepare could result in unexpected tax assessments, reputational risk, and a competitive disadvantage.

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