Global tax points for insurers

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Foreword

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

In this issue, we explore a number of developments in tax for insurance companies. First, we share some thoughts on the tax consequences for insurers of the business restructurings that are likely to happen as a consequence of the UK's withdrawal from the European single market. Over the years, insurance companies in the UK have enjoyed a more benign value-added tax (VAT) treatment of outsourced functions compared to some of their competitors on the mainland, and this difference is likely to be a key factor in determining post-Brexit operating structures. From a corporate tax point of view, too, it will be important to plan carefully for structural changes. We highlight some of the important considerations in that process.

Next, we look at the impact on insurance groups of the Section 385 regulations in the US. These regulations, published in final form in October last year, provide guidance on how to determine whether interests in related corporations should be treated as debt or equity and how this should be documented. We provide some guidance on what insurance groups should be thinking about in this complex area and suggest an approach for dealing with the practical implications of these new rules.

We then look at recent tax developments in Argentina and their impact on insurance groups. Inbound investors will welcome the reduction of the tax burden on profits distributed by way of dividend. Also welcome will be the forthcoming reduction in the Minimum Presumed Income Tax level. It is interesting to note that compliant taxpayers are being granted relief from the net equity tax for a period of three years and a new voluntary disclosure regime has also been introduced — a clear indication that the government is serious in its efforts to improve compliance and its willingness to look at approaches that favor the compliant taxpayer.

Finally, we discuss how the Australian government is taking the transparency and anti-avoidance agenda forward. Australia has been at the forefront in driving the Organization for Economic Co-operation and Development's (OECD) agenda for base erosion and profit shifting (BEPS). The recent introduction of their Multinational Anti-Avoidance Law (MAAL) and their diverted profits tax (DPT) highlights their determination to augment the tools available to deal with perceived abuses by multinational groups.

We look at how these rules might affect multinational insurance groups, particularly in the context of cross-border reinsurance transactions, and we suggest some practical steps they should take to protect their position.

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

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Brexit uncertainty: the rationale and practicalities of moving to a European risk carrier

With the outcome of Brexit negotiations uncertain, UK insurers operating across the European Union (EU) have an opportunity to revisit their current operational structures and position their organizations for a smooth transition.

Many UK-based insurers currently trade in the EU through branches and benefit from EU passporting rights to supply services across the EU. As a result of Brexit, passporting rights for UK entities may be lost. Absent any other action, in order to stay in business in the EU, UK-incorporated insurers would need to obtain branch authorization in each Member State or, where such local third-country branch authorization is unavailable, incorporate a new entity in that state.

Local authorization or incorporation of branches could carry a heavy capital cost. For those active in only a few Member States, if this is not palatable the alternatives may be to cease operations or dispose of EU branches. There are a number of practicalities from a tax viewpoint to be considered in light of this. Insurers operating in a number of states may consider alternative structures with an EU or European Economic Area[1] (EEA) incorporated risk carrier.

The choice of location in setting up an EU insurer is driven generally by nontax criteria, though the effective tax rates in the EU host country should be considered. Regulatory capital requirements inevitably will drive group structure. Therefore, financing, reinsurance and repatriation of profits are important, particularly in ascertaining relative cost for each tax. In particular, it should be noted that UK financial service companies enjoy a relatively favorable interpretation of EU VAT legislation. Under a different jurisdiction, entities that depend on outsourced services, especially cross-border, could face the burden of additional irrecoverable VAT.

Transferring business from a UK to an EU company may result in a taxable gain or a supply subject to VAT. It may be possible to mitigate a taxable gain on transfer of business by reliance on the EU Merger Directive *(Council Directive 2009/133/EC of 19 October 2009)*, which provides for tax neutrality on cross-border mergers between EU companies. Achieving a cross-border merger necessitates merging the UK insurer into an authorized EU insurance company, creating one merged entity in the EU. This transaction requires a UK portfolio transfer to move underlying insurance policies, which may be complex and expensive. While tax neutrality should occur when the merger directive conditions are met, this will depend on the implementation of the merger directive in each relevant EU jurisdiction where business is transferred and is likely to be subject to local rulings. Furthermore, since the merger directive generally applies only to transactions between two EU companies, if reliance on the merger directive is sought, any such transaction should be executed while the UK is still part of the EU.

[1] The European Economic Area (EEA) is the area in which the Agreement on the EEA provides for the free movement of persons, goods, services and capital within the European single market.

[2] Company registered in accordance with the corporate law of the EU; such a company may more easily transfer to or merge with companies in other Member States.

In addition to cross-border mergers, the merger directive allows for the concept of a "partial division," whereby a "branch of business" is transferred to another company in exchange for shares. While a cross-border demerger is not a concept under EU corporate law, transferring business from one company to another in exchange for shares may nonetheless be achievable under UK and local law.

In many cases, local restructuring provisions arising from local implementation of the merger directive enable such a transaction to be achieved in a tax-neutral manner. This requires careful consideration on a case-by-case basis.

Another way to transfer insurance business from the UK to the EU (rather than transfer the business into an entity established in another Member State) is to convert a UK insurance company into a Societas Europaea (SE),[2] which will subsequently migrate to another Member State. The benefit here is that there is no change to the operating entity, no transfer of business and the ability of the SE to move its registered offices between Member States should the need arise. However, SE migration has not, historically, been widely adopted, and it requires approval from the UK regulator. We also note that the SE rules also require employee participation in corporate governance. Early consideration of this route is therefore essential.

In any proposed transaction, it is important that the VAT transfer of going concern provisions apply; otherwise, there is a risk that the transfer is taxable.

The preferred response to Brexit ultimately will depend on the nature and scale of an insurer's business in the EU and the goal is to achieve a smooth transition at minimal cost. As the optimal path to a European risk carrier will, in many cases, be reliant on European legislation, time is of the essence to carry out any restructuring prior to the UK's exit from the EU.

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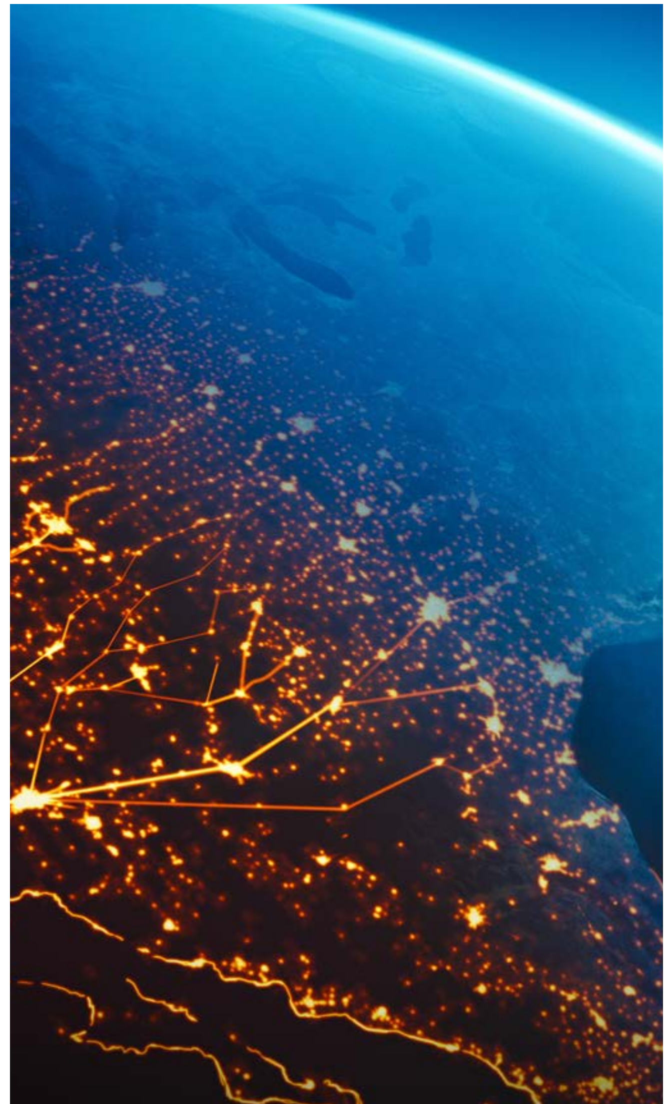
New US regulations provide welcoming relief for related- party debt

The insurance industry realized significant changes in October 2016 with the release of much-anticipated regulation by the U.S. Internal Revenue Service (IRS) and U.S. Treasury Department. Section 385 Regulations establish temporary and final documentation requirements that represent a generally welcome regime for characterizing related-party debt compared to earlier proposals.

Section 385 Regulations have seen extensive lobbying by the business community and the insurance industry. Proposed regulations issued 5 April 2016 were amended with numerous exceptions and exclusions, including specific carve-outs for regulated insurance companies.

The final and temporary regulations establish extensive documentation requirements for related-party indebtedness (Documentation Rule) and treat certain related-party interests that otherwise would be treated as indebtedness for US federal tax purposes (Recharacterization Rule) as stock. The Recharacterization Rule generally applies to tax years ending on or after 90 days following final publishing of regulations in the Federal Register and does not apply to debt instruments issued prior to 5 April 2016. The Documentation Rule generally applies to debt issued on or after 1 January 2018.



Exclusions apply

Section 385 Regulations only apply to US corporations (including, among others, section 953(d) companies and disregarded entities with domestic corporate owners). There are also exclusions for certain financial institutions:

- Reinsurance and funds-withheld reinsurance are not subject to the Documentation Rule. Moreover, the final regulations provide an exception from the documentation requirements for certain instruments issued by an excepted regulated financial company or insurance company.
- Insurance and reinsurance contracts generally would not be subject to the Recharacterization Rule except for limited circumstances. The Recharacterization Rule does not apply to a debt instrument issued by a regulated insurance company, which is defined as: (i) subject to tax under the Internal Revenue Code; (ii) domiciled or organized under the laws of a US state or the District

of Columbia; (iii) licensed, authorized or regulated by one or more US states or the District of Columbia to sell insurance, reinsurance or annuity contracts to unrelated persons; and (iv) engaged in issuing insurance, reinsurance or annuity contracts with unrelated persons. These requirements may exclude certain captives from qualifying for the exception.

- Although final regulations do not apply to instruments issued between members of a US consolidated group, they apply when an instrument is issued between a life insurer and a nonlife company that are not members of one consolidated group.

It is worth noting that the incoming administration or Congress may rescind the final debt-equity regulations in early 2017.

Implications for insurance companies

We recommend a careful analysis to confirm that the specific documentation requirements are met. Debt instruments issued by non-regulated entities (e.g., holding companies or service companies) may not be eligible for the exception.

The final and temporary regulations restrict the exception to companies that issue insurance (or reinsurance contracts) to unrelated persons. It appears that a member of a consolidated group that is not a regulated insurance company on a separate-entity basis may not be able to rely on the activities of a consolidated group member that is a regulated insurance company on a separate-entity basis. The exception does not apply to a Section 953(d) company.

Furthermore, as Treasury declined to treat newly acquired life insurance companies as part of a consolidated group, these insurers must rely on other previously outlined exceptions and exclusions.

We recommend that insurance companies consider these next steps:

- Conduct an impact assessment to prepare for Section 385 Regulations as soon as possible
- Explore processes and possible technological solutions to monitor debt instruments that are
- not exempt from these regulations
- Engage with internal stakeholders, such as treasury, finance and capital teams, impacted by Section 385 Regulations.

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Insurance industry welcomes Argentine tax law changes

During 2016, the Argentine government introduced significant changes to the Argentine tax laws with a clear purpose of reducing the tax burden for corporations. Highlights were the elimination of the 10% withholding tax on dividend distributions that was applicable to foreign investors and to Argentine resident individuals and the consequent reduction of the effective income tax rate on dividend distributions from 41.5% to 35.0%.

Other welcome changes for the insurance industry include the elimination of the Minimum Presumed Income Tax starting with fiscal year 2019 — currently applied at a 0.20% rate on the value of the assets of local insurance entities; and the reduction from 0.50% to 0.25% of the net equity tax applicable on stock owned by foreign shareholders in Argentine companies. In addition, "compliant taxpayers," which are defined as those that properly filed their tax returns for fiscal years 2014 and 2015, will be exempted from the net equity tax for fiscal years 2016, 2017 and 2018. The deadline to apply for these benefits is 31 March 2017.

A tax debt settlement plan was also introduced that provides an exemption from fines and penalties; total or partial exemption from compensatory and punitive interest; reduction of up to 15% of the eligible consolidated tax debt;[3] and the possibility of paying the tax debts in up to 90 monthly installments with an interest rate ranging from 1.0% to 1.5%. The plan includes, among others, federal taxes, social security taxes and tax liabilities subject to administrative or judicial claims. This is an opportunity for Argentine insurance companies to review any potential tax contingencies and strategically define whether they should be included in the settlement plan; the deadline to apply for this plan is 31 March 2017.

In line with transparency trends around the world, the government has enacted a voluntary disclosure regime releasing taxpayers from any past tax omissions, interest, fines and any related civil, administrative and criminal prosecution. Within this context, the insurance industry is impacted by insurance coverage contracted abroad for Argentine residents (e.g., a universal life insurance product contracted abroad). Argentine laws forbid contracting insurance abroad and determine that the penalty for infringing this prohibition could reach **25 times** the amount of the premium paid to the foreign direct insurer.

In this respect, when the voluntary disclosure regime was enacted, there was uncertainty as to whether the declaration of any foreign currency or investments with insurance policies abroad could still trigger the imposition of this penalty. The local tax authorities have clarified their position and confirmed that no penalty will be imposed.

In summary, the above changes reflect the current inclination of the Argentine government to attract investments and improve the Argentine economic and tax environment. It is also expected that the Argentine Congress will establish a commission with the specific purpose of analyzing and evaluating proposals to reform the Argentine tax system, which should be positive for the insurance sector.

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[3] Payment of the entire tax liability upon filing.

New measures in Australia address perceived tax avoidance by global entities

The current global tax landscape is driven by tax transparency. We are seeing a paradigm shift in the way tax authorities collaborate, share and exchange information. For insurers and reinsurers, this means tax authorities will be able to take a closer look at their internal reinsurance arrangements. This is within the context of arrangements involving group reinsurers domiciled in counties with low or nil tax rates and where the profit per employee is disproportionate to the economic activity that generated those profits.

Augmenting the OECD's transparency initiative, the Australian government introduced new anti-avoidance measures (MAAL and DPT) as part of its general anti-avoidance rules. Australia has been at the forefront of a tax revolution, and these measures are meant to tackle perceived tax avoidance by significant global entities (SGEs).

The Australian transfer pricing rules form the foundation of these new measures. They are designed to apply the arm's-length principle through a holistic analysis of the conditions that reflect the totality of the commercial or financial relations between related parties and could be expected to operate between independent parties. These rules give the Australian tax authorities widespread powers to reconstruct a transaction or an arrangement to the extent that the "form" of the commercial and financial relations are inconsistent with the "substance" of those commercial and financial relations and result in a transfer pricing benefit (reconstruction provisions).

The Australian income tax rules allow insurers to make an election on the Australian tax treatment of their reinsurance arrangements with non-Australian reinsurers. This election determines the income tax outcomes of reinsurance premiums paid and claim recoveries received under a reinsurance contract that includes the applicability of the transfer pricing rules.

The MAAL is designed to counter the erosion of the Australian tax base by SGEs (i.e., entities having a global turnover of more than AUD1 billion) using artificial and contrived arrangements to avoid attributions of profits to a permanent establishment in Australia. The MAAL is

effective from 1 January 2016 and targets foreign entities that supply goods and services directly to Australian customers and where there is some direct connection to the supply taking place in Australia by an associate or agent of the foreign entity. Under such circumstances, where the one principal purpose of the arrangement includes obtaining a "tax benefit," the MAAL is likely to apply.

In an article published in the *Australian Financial Review* on 9 December 2016, Second Commissioner Jeremy Hirschhorn was quoted saying that 105 companies had been identified as being within the scope of the MAAL. According to him, the Australian Taxation Office (ATO) has seen 24 companies fundamentally restructure their Australian operations and is expecting most if not all of the remainder to also restructure and book sales in Australia. Such restructuring is due in part to the significant penalties that can be levied by the ATO if the MAAL is applied to an SGE's operations and the inability to obtain any relief from double taxation as this law operates outside of Australia's tax treaties.

Following the MAAL, DPT was introduced by the Australian Government in the 2016–17 Budget and, in late November 2016, the Treasury released an Exposure Draft (E) and an Explanatory Memorandum (EM) for DPT implementation. DPT is meant to apply to income years commencing on or after 1 July 2017 and broadens the existing general anti-avoidance rules to allow the ATO to impose DPT on multinational businesses that transfer profits to offshore associates. Under the DPT, the Commissioner is empowered to impose a 40% penalty tax on profits that are deemed to be artificially diverted from Australia by SGEs. Similar to the MAAL, DPT also considers the "principal purpose or effective tax mismatch" test and "economic substance" as determinative elements.

What do the above measures mean for insurers and reinsurers?

For insurers, the key transaction or arrangement is likely to be reinsurance arrangements with non-Australian reinsurers. It is a well-accepted fact that every reinsurance arrangement has bespoke terms and conditions. As a result, it is imperative that these arrangements reflect their economic substance and commercial benefits, in particular, nontax-related financial benefits (e.g., capital relief, capital efficiency and growth in domestic business). "Justified Trust" is an emerging concept within the Australian tax space and is a new approach that the ATO proposes to take to obtain assurance of each taxpayer's tax position. Transfer pricing arrangements, therefore, should appropriately reflect the functions performed and allocate an arm's-length contribution to the economic activities undertaken and the corresponding risks assumed in both jurisdictions.

Insurers should consider undertaking an analysis of whether the MAAL might apply, especially where there is direct supply of insurance products or services to Australian customers by offshore group insurance entities and how DPT will impact reinsurance arrangements with foreign reinsurers, particularly those domiciled in countries where the income tax rate is less than 24% (i.e., less than 80% of the Australian tax rate). In addition, preparation of contemporaneous transfer pricing documentation in accordance with Australian transfer pricing is highly recommended in order to mitigate the levy of higher penalties.

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