Deloitte.

Insurance Tax Insight
The Global Tax Reset: BEPS & Insurance

On 5 October 2015, the OECD published 13 papers outlining consensus actions under the base erosion and profit shifting (BEPS) project. The output under each of the BEPS actions is intended to form a comprehensive and cohesive approach to the international tax framework, setting out minimum standards, best practices or recommendations for governments to adopt. This "Global Tax Reset" will be wide ranging and will affect companies operating in all industries, with work on some aspects continuing into 2016/17. While the BEPS agenda is not specifically targeted at the insurance industry, those operating in the industry will need to focus particular attention on changes to the permanent establishment (PE) threshold, transfer pricing aspects, and accessing treaty benefits. The OECD's BEPS actions will see an increased shift in focus to 'people-based' substance and, given the nature of insurance business models, topics which may require further analysis by corporates will include the alignment of profit and substance and the role that risk and capital play in any such alignment.

Permanent establishments

The final report in relation to preventing the artificial avoidance of PE status (Action 7) builds on previous discussion drafts and puts forward recommendations for changes to the OECD model treaty. While the report covers a range of issues from fragmentation of activities, to specific activity exemptions and the splitting of contracts, changes to the dependent and independent agent rules are of particular interest. While the proposals no longer single out the insurance industry for particular measures, the general changes proposed to the PE threshold and the focused shift from a legally binding test to a substance-based analysis are likely to have an impact, particularly for those insurance groups that have mobile sales staff, agents and representative offices across various jurisdictions. Broadly, the final proposals aim to:

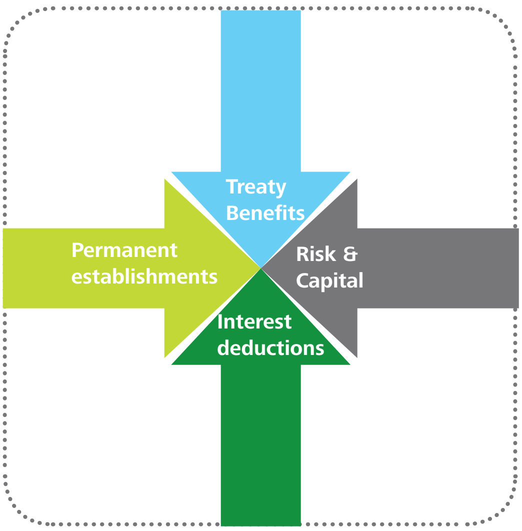
- Tighten the agency PE rules to include contracts where the intermediary "habitually concludes contracts, or habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise" (clearly extending beyond the location of signing a contract) and
- Narrow the requirements for an agent to be considered "independent", such that an agent will not be considered independent where the agent acts exclusively or almost exclusively for one or more enterprises to which it is closely related. Closely related (which replaces "connected" from the previous discussion draft) is broadly defined based on the vote and value of a company's shares (directly or indirectly more than 50 per cent).

The lowering of the PE threshold and the narrowing of the independent agent exemption contained in Article 5 of the OECD Model Treaty will be of concern to insurers given the potential impact on existing business models as many insurance groups operate across jurisdictions on a freedom of services basis without a taxable presence. The commentary provides limited guidance and examples on the phrase "habitually concludes contracts, or habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise", which replaces "negotiates the material elements of contracts" as contained in the previous discussion draft. The commentary notes that the phrase will "typically be associated with the actions of the person who convinced the third party to enter into a contract with the enterprise" (i.e. "acts as a sales force" in respect of the negotiation of contracts). Establishing a detailed understanding of an insurance company's nexus with a foreign jurisdiction will be important, including considering where people who play the principal role in the conclusion of contracts are located and if standardised insurance products are being sold.

It is not helpful that there is only limited commentary in respect of the proposed changes. As a result, revenue authorities in different countries may well interpret the proposed new language differently, which could potentially increase tax risk and tax liabilities for insurance companies. Broadening the scope of agents' activities that could give rise to a PE would also likely lead to a greater number of disputes over taxing rights involving tax administrations globally and open up the potential for increased instances of double taxation. Where such proposals are adopted there would clearly be a need for materially improved dispute resolution mechanisms, something which Action 14 seeks to address.

Further additional guidance will be issued in respect of the attribution of profits to PEs arising as a result of the proposed threshold changes. The work on the new guidance is expected to be completed by the end of 2016, in time for the conclusion of Action 15 on the multilateral instrument to implement changes to the PE threshold in tax treaties.

Areas affecting Insurance



Transfer Pricing Aspects: Risk & Capital

Actions 8, 9 and 10 of the BEPS project seek to align transfer pricing outcomes with value creation and have been released as one report. The Actions seek to amend various chapters of the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations to seek to ensure that the allocation of profits is aligned with the economic activity that produced the profits, essentially creating a closer link to commercial substance.

Of particular interest to insurers is the detail contained in Action 9, which focuses on the contractual allocation of risks, and the resulting allocation of profits to those risks in respect of related-party transactions. As insurance is fundamentally a business centred on "risk transfer", the details of Action 9 are of particular relevance. The revised guidelines seek to focus not only on the contractual relations between the parties to a transaction, but also on where the key functions are located, the conduct of the parties involved, and on the commercial rationale for the transaction. Where transactions between related parties lack commercial rationality, the guidance provides that such actual transactions should not be recognised. One example provided includes that of a captive insurer in an effort to demonstrate a commercially irrational transaction. The example covered broadly a situation where third-party insurance was not available and thus it was concluded that the related-party arrangement should be disregarded, noting that non-insuring may be a more realistic alternative.

With respect to the reallocation of risks, to contractually assume risk, a party must exercise control over the risk and have the financial capacity to assume the risk. Although there is no clear test to determine control over risk, the factors considered include: (1) performance of the decision to take risks; (2) the performance of responding to risks associated with the business opportunity; and (3) performance of risk-mitigation activities. Clearly, merely formalising decisions in, for example, board meetings where documents are signed does not qualify as exercising a decision-making function sufficient to demonstrate control over risk. The guidance permits day-to-day risk mitigation activity to be outsourced as long as the party outsourcing the risk mitigation activity exercises control over the party doing the day-to-day, risk-mitigating activity. The guidance provides a six-step process to determine the entity incurring risk. Irish insurance companies with limited employees and a large degree of outsourced services (such as in the cases of many captive insurers) will need to pay particular attention to the new rules and focus on the key role and skills of relevant people, including the Board of Directors, in managing the company's affairs.

Understanding the conduct of the parties to a contract will be relevant to assessing whether there are contradictions between the contractual arrangements and the conduct of the relevant parties. It is the key people aligned with the risk that will dictate substance going forward. The parties' actual conduct should be used to clarify or supplement the terms of the contract, or replace the contract if it is not supported by the conduct of the parties. Essentially, the question that needs to be answered is, "Can the party contractually assuming the risk demonstrate control over the risk?" This is of particular relevance to reinsurance and captive (re)insurance entities (including situations where there is significant capital in offshore reinsurance entities or potentially other intragroup reinsurance arrangements). The emphasis will now be on suitable pricing and substance and an increased focus on people functions over contractual arrangements. Substance will now require both financial and operational oversight over risks assumed and insurance groups will need to be able to demonstrate that the decision-making and oversight takes place in the right place, particularly in the case of any potential future transfer pricing audits. What is clear is insurers will need to quantify the potential impact of Action 9, particularly with regard to the intragroup transfer of risk through reinsurance.

Treaty benefits

Action 6 of the BEPS project seeks to prevent the granting of treaty benefits in inappropriate circumstances, with reference to treaty abuse, treaty shopping, or claiming treaty benefits in situations where such benefits were not intended to be granted. The final report includes new treaty anti-abuse rules and presents countries with a choice over the type of treaty abuse rules to implement. Broadly, the report suggests either:

- A specific anti-abuse rule, the limitation on benefits ("LOB") rule, which limits the availability of treaty benefits to entities that meet certain conditions, based broadly on the legal nature, ownership and activities of the entity. The rule seeks to ensure there is a sufficient link between the entity and its state of residence (essentially to ensure it has not been established for the principal purpose of giving residents of a third state access to treaty benefits) or
- A general anti-abuse rule, the principle purpose test ("PPT") rule, which is based on the principal purpose of transactions or arrangements. If the principle purpose of any transaction or arrangement is to obtain treaty benefits, such benefits will be denied unless it can be shown that granting such benefits would be in accordance with the object and purpose of the provisions of the treaty.

The report provides the options of either combining an LOB with a PPT, adopting an LOB with anti-conduit rules, or alternatively adopting a PPT alone. Most countries in deciding between an LOB and a PPT will most likely opt for the latter, including (it is expected) in Ireland. The U.S. LOB rules are currently undergoing a public consultation and the OECD will await its outcome in considering its impact on Action 6. The PPT is similar in respects to general anti avoidance provisions contained in existing Irish tax legislation except that it covers taxes outlined in the treaty. A clear lack of detailed and comprehensive guidance and examples, however, opens up the possibility of ambiguity and the potential for disputes as to its application between tax administrations globally. Action 6 is of particular relevance to insurance companies, which rely on provisions of treaties – for example, with regard to accessing reduced withholding tax rates on premium payments and investment income. It is envisaged that the measures will be implemented into existing tax treaties through the multilateral instrument, which will be agreed under Action 15.

Interest deductibility

Action 4 of the BEPS project seeks to limit base erosion involving interest deductions and other financial payments. The OECD's concerns centred on three risk areas:

- The placing of higher levels of third-party debt in high tax countries
- The use of intragroup loans to generate interest deductions in excess of actual third-party interest expenses and
- The use of third-party or intragroup financing to fund the generation of tax-exempt income.

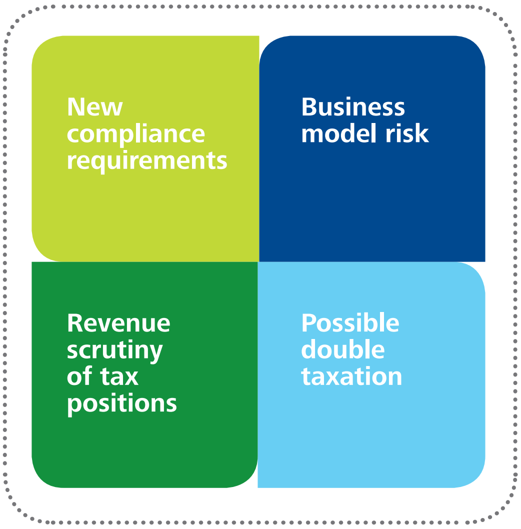
In analysing best practice in this area, the report puts forward a fixed-ratio rule and a group-ratio rule, which broadly place limits on net interest deductions as a percentage of EBITDA within a predefined range. However, the report does recognise that the banking and insurance industries have specific features that need to be taken into consideration and, therefore, there is a need to develop suitable and specific rules that address BEPS risks in these industries. Further work is thus required in this area, which is expected to be completed in 2016. As discussed further below, changes to interest deductibility rules are not a priority for Ireland at this point.

Other Actions

Action 13 on transfer pricing documentation and country-by-country (CbC) reporting will have a direct impact on the insurance industry. The three-tier transfer pricing requirements of master file, local file and CbC report will present tax authorities with a much greater level of detail on a group's global operations.

The recently released Finance Bill introduces legislation to give effect to CbC reporting. Multinational companies, both Irish-headquartered and foreign groups with Irish operations, with global revenues in excess of €750 million will be required to file a CbC report for accounting periods commencing on or after 1 January 2016. The €750 million threshold will be applied on a preceding year basis. The first reporting will be the 2016 financial year. The deadline for filing the CbC report is 12 months after the end of the accounting period.

Insurance companies are facing:



Insurance companies will need to consider the impact the increased transparency will have, both in terms of the capability of their internal systems and processes and the commercial implications arising from this increased transparency. For instance, in a captive insurance context mismatches between profits, capital base and number of employees will likely come under greater scrutiny from tax authorities, particularly in instances where the business models of insurance are not fully appreciated. Clear documentation evidencing substance and oversight will be required.

With respect to Action 5 on countering harmful tax practices, the report broadly establishes minimum standards with regard to determining whether preferential regimes take sufficient account of the need to reward substantial activities. The insurance sector is identified as operating within a preferential regime. Also action 2 on Hybrid Mismatches could potentially have an impact on insurance groups where certain financial instruments are used.

In the OECD BEPS reports, a number of the actions are described as "best practice" or "common approach": controlled foreign company rules; interest deductibility (discussed above); and hybrid mismatches. These areas are not minimum standards requiring early action. In a recently updated document in October 2015 on Ireland's International Tax Strategy, the Irish Government have stated that Ireland will continue to engage constructively with international developments on these issues, which it is understood means that for the moment there should be no changes to Irish domestic laws in these areas.

Deloitte observations

A Global Tax Reset is taking place as a result of the convergence of the OECD's BEPS project, reactive country legislation, increased media attention on tax issues and the sharing of information between governments. This reset will be felt among all industries across the economy and the level of unprecedented change will have a broad and cascading impact on many businesses, including insurance companies.

As the OECD BEPS Action items have largely now been finalised, implementation can be expected in most jurisdictions. Indeed, many countries have already moved ahead with unilateral action, which is already having an impact. Ireland has committed to the BEPS process and will play a full part in implementation, including close engagement at the OECD level on the multilateral instrument, which will provide for changes to existing tax treaties to deliver upon a number of published OECD BEPS Actions.

Those in the insurance industry will need to assess their ability to comply with new requirements, particularly with regard to substance and increased reporting, and understand areas of vulnerability based on current operating models. For instance:

- Existing structures may need to be adapted to manage new approaches as a result of the BEPS actions and specific local jurisdictional rules, for instance as a result of an expanding PE concept
- Transfer pricing documentation may need to be updated and strengthened and systems put in place to manage new disclosure requirements including the collection and reporting of required data for CbC reporting and
- Substance and the allocation of risk and capital within insurance groups may need to be evaluated and restructured for sustainability into the future.

What is clear is that success in dealing with the result of the BEPS project in an evolving tax environment will depend on developing an ability to respond to new compliance requirements and evolving a business and tax strategy to mitigate risk. Now is the opportune time, as enough clarity now exists to undertake more specific risk assessment and planning. Such actions will help to position insurance companies to be able to respond to the likely eventualities of a rapidly changing international tax landscape.

What does the Global Tax reset mean to you?

Tax Function Transformation

		Business impact	ETR impact	Risk profile
Risk assessment and stakeholder management	• Assess key stakeholders and their interest in / sensitivity to tax matters • Early BEPS impact assessment should minimise cost and risk	✓	✓	✓
Business structures	• Greater focus on driving value through supply chain and centeralised services • Move to a more integrated approach	✓	✓	✓
PE Risk & Treaty Access	• Lower PE threshold • Increased focus on people functions and activities • Anti-abuse rules - impact treaty access	✓	✓	✓
Financing	• Actions on hybrids and interest deductions actions will likely reduce interest deductions		✓	
TP and Risk & Capital	• Two TP files needed - Master & Local • Aligning profits with value creation • Risk allocation backed with substance and commercial rationale		✓	✓
County by county reporting	• New compliance obligation • Increasing information flows • Compliance costs/systems			✓

Contacts

For any queries, please contact any of the below or your usual Deloitte Dublin contact.

Conor Hynes
Partner
T: +353 1 417 2205
E: chynes@deloitte.ie

Eugene O'Keeffe
Director
T: +353 1 417 2434
E: eokeeffe@deloitte.ie

Peter McGeoghegan
Director
T: +353 1 417 2293
E: pmcgeoghegan@deloitte.ie

Ronan Connaughton
Senior Manager
T: +353 1 417 2854
rconnaughton@deloitte.ie

Rachel Henry
Assistant Manager
T: +353 1 407 4825
E: rhenry@deloitte.ie

Be sure to visit us at our website
deloitte.com/ie/tax

Dublin
Deloitte
Deloitte & Touche House
Earlsfort Terrace
Dublin 2
T: +353 1 417 2200
F: +353 1 417 2300

Cork
Deloitte
No.6 Lapp's Quay
Cork
T: +353 21 490 7000
F: +353 21 490 7001

Limerick
Deloitte
Deloitte & Touche House
Charlotte Quay
Limerick
T: +353 61 435500
F: +353 61 418310

Galway
Deloitte
Galway Financial Services Centre
Moneenageisha Road
Galway
T: +353 91 706000
F: +353 91 706099

deloitte.com/ie/

About this edition
This publication is designed to keep readers abreast of current developments, but it is a general guide only and is not intended to be a comprehensive statement of the law or regulations and not an exhaustive treatment of those current developments. Accordingly, the information in this publication is not intended to constitute tax, accounting, legal, investment, consulting, or other professional advice or services. It therefore cannot be relied on to cover specific situations; application of the principles set out will depend upon the particular circumstances involved and we recommend that you obtain professional advice before acting or refraining from acting on any of the contents of this publication. Deloitte would be pleased to advise readers on how to apply the principles set out in this publication to their specific circumstances. If you would like to discuss any of the issues set out in this newsletter please contact your usual Deloitte contact or any of the Deloitte insurance contacts listed on the following page and they will be able to help you.