cutting through complexity

BEPS – latest developments for insurers

Event Date: Wednesday 25 March, 2015

Event Time: 9:00 am – 10:00 am (Eastern)

2:00 pm – 3:00 pm CET

Agenda

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Where are we on BEPS –

Action items most relevant to insurers

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BEPS actions 8-10

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Country by Country Reporting

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Managing communications with the tax authorities

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Where are we on BEPS?

BEPS Roadmap

1	Digital Economy	*Report on challenges complete; VAT discussion draft Dec 2014, final report Dec 2015*
2	Hybrid Mismatches	*Recommendations complete; guidance expected Sep 2015*
3	CFCs	*Discussion draft April 2015; finalised Sep 2015*
4	Interest deductions	*Discussion draft Dec 2014; best practices due Sep 2015, OECD guidelines in Dec 2015*
5	Harmful tax practices	*Initial report complete; strategy for non-OECD members Sep 15 final criteria Dec 2015*
6	Treaty abuse	*Finished - draft on Collective Investment Vehicles Nov 2014, finalised Sep 2015*
7	Definition of PE	*Discussion draft Oct 2014, consultation Jan 2015, finalised Sep 2015*
8	TP- Intangibles	
9	TP- Risk & Capital	**Consolidated**
10	TP- High Risk	*Intangibles: Paper 1 finished; discussion draft on special measures Apr 2015* *Low-value adding services - discussion draft Oct 2014* *Risk, recharacterisation, commodity transactions, profit splits - discussion drafts Dec 2014* *Consultation in March 2015. All work finalised by Sep 2014*
11	BEPS data	*Request for input Aug 2014, discussion draft Jan 2015, finalised in Sep 2015*
12	Mandatory Disclosure	*Public consultation May 2015, finalised in Sep 2015*
13	TP- Documentation	*Final except for implementation mechanism (due Feb 2015)*
14	Dispute Resolution	*Discussion draft Dec 2014, finalised in Sep 2015*
15	Multilateral Instrument	*Feasibility report complete; draft mandate in Jan 2015 with international conference due Dec 2015*

2014 | 2015

We are here

KPMG International, 2015

Key points for Insurers ………. a reminder as to what is changing

Global view of value chain

BEPS Action Items most relevant to Insurance

All of the BEPS Actions have the potential to affect insurers, but the following Actions are most likely to have a significant impact:

- **Action Item 7 - Permanent Establishments (PE):** a wider definition of what constitutes a permanent establishment is proposed, including insurance specific suggestions. This may result in a PE being created through the use of dependent agents or the creation of a PE in any country where premiums are collected. Could materially increase insurance group's compliance burden.

- **Action Item 9 – Risk & Capital: – transfer pricing rules:** aims to prevent BEPS being undertaken through transferring risks among, or allocating excessive capital to, group members. Current proposals are very broad and do not adequately deal with insurance sector, where risk is a key component of the business and the location of capital is subject to regulation.

- **Action Item 13 – Transfer Pricing Documentation:** Country by Country reporting (interaction with CRDIV). Preparation of "BEPS-proof" documentation.

BEPS Action Items most relevant to Insurance

All of the BEPS Actions have the potential to affect insurers, but the following Actions are most likely to have a significant impact:

- **Action Item 4: Interest Deductions:** could impact funding structures for unregulated vehicles within insurance groups.

- **Action Item 6 – Treaty Benefits:** changes could have an impact on withholding taxes arising on some premium payments and investment income.

- **Action Item 3 – CFCs:** could affect the location of some insurance vehicles, including captives.

- **Action Item 2 – Hybrid Mismatches:** could have an impact, depending on use of financial instruments and arbitrage structures.

Actions 8 -10

Risk, Re-characterisations, Special Measures & Profit Splits

Introduction to Risk and Re-characterisations

Key points:

- A major rewrite of Chapter 1
- Risks should be analysed with specificity
- At arm's length risk is most likely to be assumed by parties that manage or control it
- Re-characterisation is becoming non-recognition

Risk and Recharacterisation – Risk Example

Insurance carrier	Liquidity management charge → ← Investment management services	Investment management
▪ Client relationship ▪ Underwriting decisions, issuing the policy	Functions	▪ ALM ▪ Investment risk ▪ Input into capital management ▪ Input into reserving (discount rates for life and pensions business)
▪ Underwriting profit and investment income	Remuneration	▪ Investment management fee

- Central investment management team manages investment risk and interest rate risk on behalf of local regulated insurance carriers.
- Investment returns are a key component of insurance companies' profits. Where loss ratios are close to 100%, it may be the main source of profits. For long-tail business, interest rate risk and investment risk are two of the main risks to be managed.
- Return to investment team is generally set to cover third-party investment management fees and leave a small margin over internal costs.
- Under proposed approach to risk and return tax authorities may argue for a higher return to investment function or make them part of profit split
- A similar analysis could apply to other risk-related functions such as actuarial and capital modelling.

Risk and Recharacterisation – Recharacterisation Example

Direct Insurer → 80% quota share → **Related Reinsurer**

Related Reinsurer → Ceding commission → **Direct Insurer**

Direct Insurer		Related Reinsurer
▪ Client relationship ▪ Underwriting decisions ▪ Issuing the policy ▪ Claims handling ▪ Investment management ▪ Capital management ▪ Outward reinsurance to third parties	Functions	▪ Writes 80% quota share intra-group ▪ Outsources routine functions to Direct Insurer or third parties ▪ Relies on Direct Insurer to notify claims
▪ 20% underwriting profit ▪ Ceding commission ▪ Investment income	Remuneration	▪ 80% underwriting profit, less ceding commission ▪ Investment income

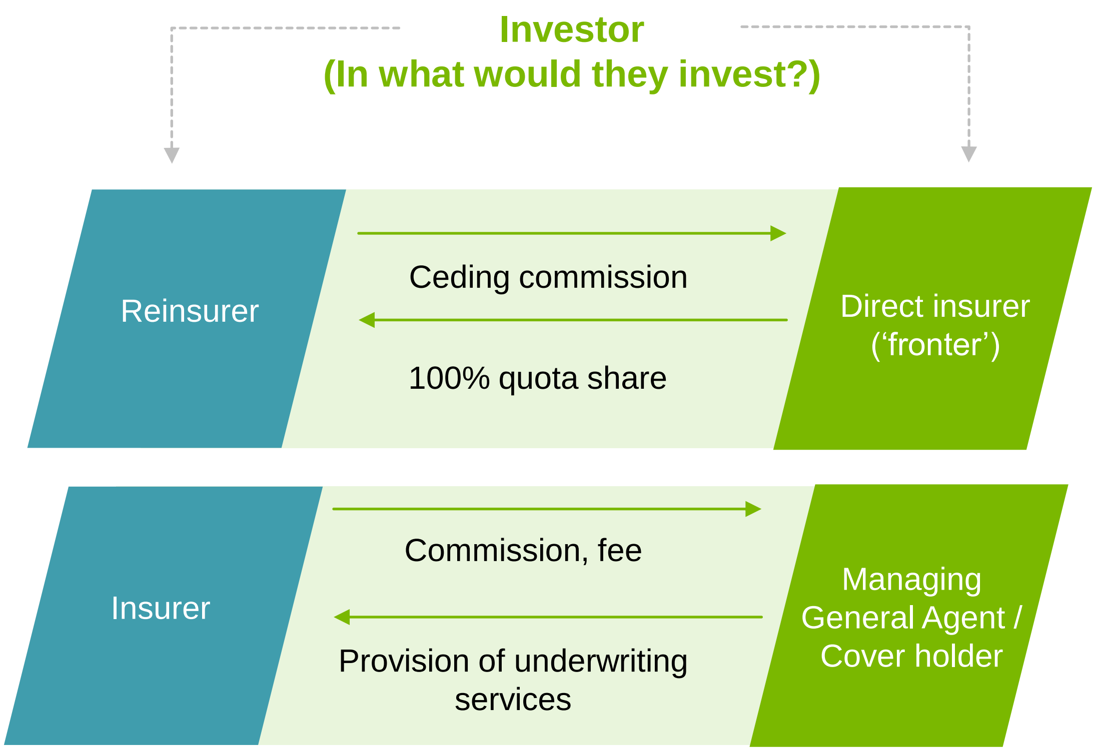
- Direct Insurer performs all ‘people functions’ in the value chain in respect of the policies it writes with third parties.
- Related Reinsurer assumes 80% of the insurance risk under a quota share and pays an arm’s length ceding commission. It has its own Board, with sufficient insurance expertise, and is well-capitalised.
- Does the arrangement offer each party a reasonable expectation to enhance or protect their commercial / financial position on a risk-adjusted basis, compared to opportunities realistically available? (para 89)
- If not, replace with something which does, including no transaction (100% retention) (para 93)
  - *Even if ceding commission “arm’s length”*
- If Direct Insurer gains capital relief and access to bigger market, and Related Reinsurer has other business so adds diversification, recognise?
- If Direct Insurer has reduced its own capital to set up Related Reinsurer, which has no other business, don’t recognise?

Introduction to Special Measures

Key points:

- Designed to deliver action plan commitment with regard to intangibles, risk and over capitalization
- Option 1: Hard to Value Intangibles
- Options 2 and 3: To deal with over capitalization
- Option 4: Minimal Functional Entity – seeks to align profits with value creation
- Option 5: A CFC solution

Special Measures – Example



Inappropriate returns to capital

- *Option 2:* Given the choice, where would an independent investor choose to invest?:
  - The entity with the capital?
  - The entity with the ability to manage the risk associated with the capital?
- Appears to contradict the fund management industry, not to mention Lloyd’s!
- *Option 3:* Apply a ‘thick capitalization’ rule, and then deem interest deductions on the excess capital
- How much capital is “too much”? And who “provided” it?

Minimal functional entity

- *Option 4:* Does the insurer / reinsurer lack the functional capability to create value by exploiting its assets (capital) and managing its risks?
- If so, mandatory profit split or reallocate all the profits up or down the chain.

Introduction to Profit Splits

Key points:

- Increased recognition of the importance of global value chains and multisided business models
- Unique and valuable contributions
- Integration and sharing of risk
- Lack of comparables and one sided methodologies
- Practical aspects of implementing a profit split

Profit Splits – Example

Parent Insurer / reinsurer

Ceding commission →

← Stop loss premium

← Quota share and stop loss

Local insurance carrier

▪ Performs all functions in respect of Parent country market ▪ Negotiates global master policies with multi-national clients ▪ Sets group underwriting standards, purchases reinsurance at group level	Functions	▪ Performs all functions in respect of local country market, in accordance with group standards ▪ Issues local polices to multi-national clients under master agreements
▪ Quota share and stop loss premium	Remuneration	▪ Retention plus ceding commission
▪ Share of profit split		▪ Share of profit split

- In this structure, the parent is the main insurance carrier in the group and has all the necessary functional capability.
- It has established local regulated carriers in different countries, and offers them protection through a quota share and a stop loss treaty. The ceding commission is set by reference to third-party agreements; the stop loss premium is calculated using the group's pricing model for third-party inward reinsurance.
- Challenges:
  - Are both parties making 'unique and valuable contributions'?
  - How comparable are CUPs?
  - Is the profit of the local carrier dependent on servicing multi-national clients of the parent, and on the parent's financial strength / expertise? But would the parent have access to these clients without a network of local carriers?
- May lead to a profit split being more appropriate, or used to corroborate single sided approach

Action 13
Country by Country Reporting

A reminder of the final template published on 16th September 2014 – Page 1

CbyC Template – Page 1										
	Revenue									
Tax Jurisdiction	Unrelated Party	Related Party	Total	Profit (loss) before income tax	Income tax paid (on a cash basis)	Income tax accrued – current year	Stated Capital	Accumulated Earnings	Number of employees	Tangible Assets other than Cash and Cash Equivalents
Country A	✘	✘	✘	✘	✘	✘	✘	✘	✘	✘
Country B	✘	✘	✘	✘	✘	✘	✘	✘	✘	✘
Not resident in any tax jurisdiction	✘	✘	✘	✘	✘	✘	✘	✘	✘	✘

KPMG International, 2015

A reminder of the final template published on 16th September 2014 – Page 2

CbyC Template – Page 2															
			Activities												
Tax Jurisdiction	Constituent entities resident in the tax jurisdiction	Tax jurisdiction of organization or incorporation if different from tax jurisdiction of residence	Research & development	Holding or Managing intellectual property	Purchasing or procurement	Manufacturing or production	Sales, marketing or distribution	Administrative, management or support services	Provision of services to unrelated parties	Internal group finance	Regulated financial services	Insurance	Holding shares or other equity instruments	Dormant	Other
Country A	Entity A	Country B		✓											
	Entity B				✓	✓			✓						✓
Country B	Entity C		✓									✓			
	Entity D					✓									
	PE 1						✓								

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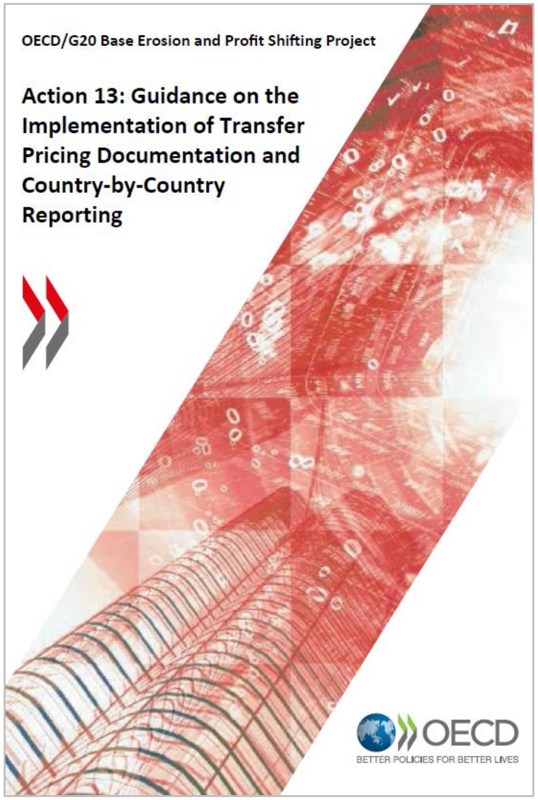
Implementation guidance



- The **ultimate parent** of the MNE group will be required to file the CbyC Report in their jurisdiction of residence
- The first period in scope will be the MNE's fiscal year beginning on or after **1 January 2016**
- Filing will be within **12 months**, so first filings will be 31 December 2017
- A report will be required each year but there will be an exemption for MNE groups with **annual consolidated group revenue** in the immediately preceding fiscal year of less than **€750m**
- There will be **no other exemptions** from reporting and no general exemption for investment funds
- Filing should be with the **parent country tax authority**

Which groups are caught?

Are you a reporting multinational enterprise (MNE)?

Key considerations

- No definition of "MNE" in Action 13 guidance
- Consider PEs / Branches
- Expanding group / acquisitions
- Different types of business structure
- Ultimate parent of an MNE group

Is the consolidated group revenue in the immediately preceding fiscal year less than €750 million?

Key considerations

- Revenue definition = third party revenue, plus other third party income within the definition for CbyC (e.g. royalties, interest, unrealised gains)
- Currency
- Fluctuating revenue
- No consolidated group accounts

Scope of entities to be reported

Reporting MNE

- "Ultimate Parent Entity of an MNE group"
- An entity which is not controlled by any other entity
- Usually where group consolidated accounts produced
- Complex for funds

Constituent Entity (CE)

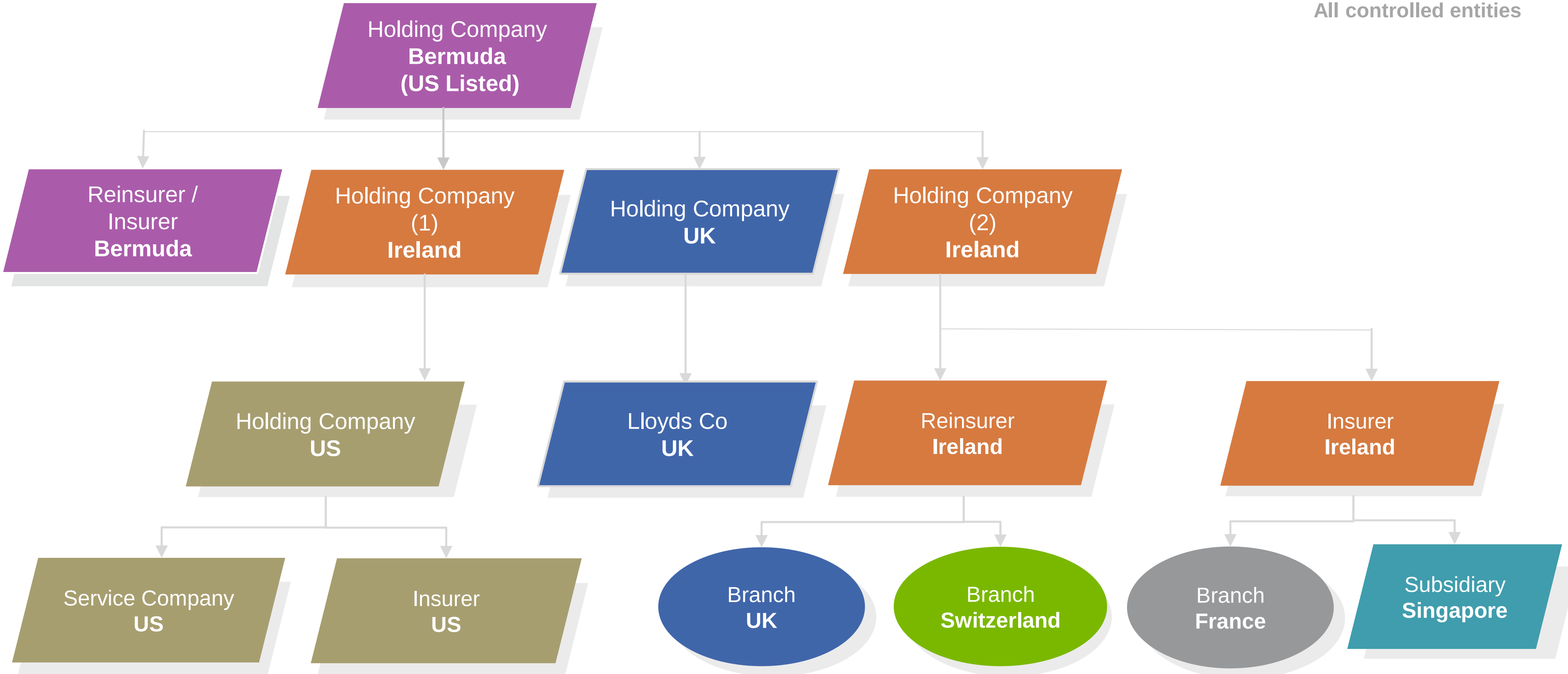
- Any entity "included in the consolidated group for financial reporting purposes"
- Broadly this should be fully consolidated entities
- Entity is all types of vehicle, so partnerships, branches, trusts etc.

PE / Branch

- Include data in the country of operation
- Except accumulated earnings and stated capital (unless regulatory requirement to hold capital)
- Representative offices?

Example Structure – Insurance perspective

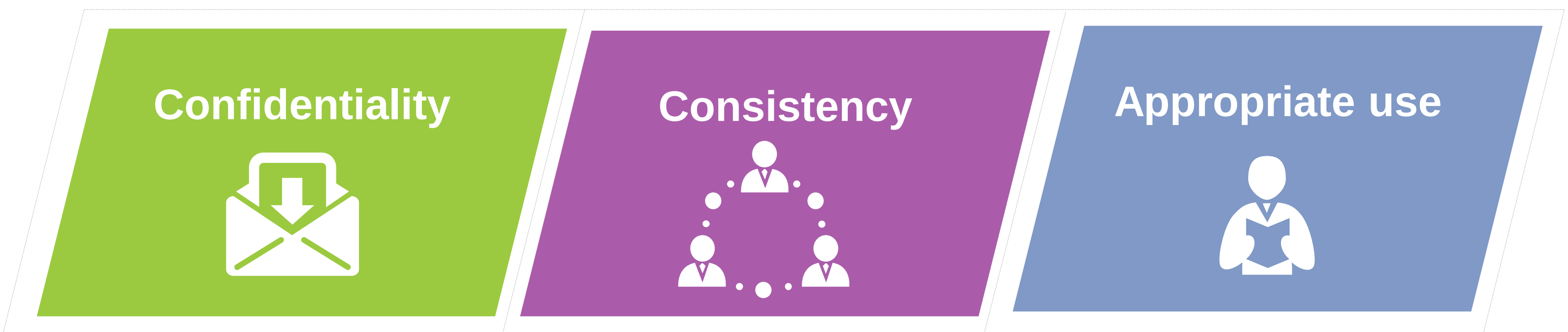
All controlled entities



Obtaining and using the report

Countries have agreed to conditions underpinning the obtaining and use of the report. These include the requirement for countries to have protections in place for the confidentiality of the report at least equivalent to those available under:

- The Multi Lateral Convention on Mutual Administration Assistance in Tax Matters, or
- Tax Information Exchange Agreements, or
- Tax Treaties meeting the standards of the Global Forum on Transparency and Exchange of Information for Tax Purposes



Filing and sharing mechanism

- The CbyC report should be filed with the **parent** tax authority.
- The parent tax authority should **automatically share** it with other tax authorities, meeting the conditions.

- The OECD **encourages** as many countries as possible to expand their **coverage of international agreements** for exchange of information to allow this to happen.

The mechanism works if:

- The ultimate parent entity is located in a country that has **implemented** CbyC reporting; and
- That country has a **sharing mechanism** in place, and has signed up to the three **conditions** set out previously.

Secondary mechanism

The clear intention of the OECD is to develop an automatic exchange of information mechanism that will give participating governments wide access to CbyC information. However the OECD is also going to consider what secondary mechanisms might be required to support this primary method.

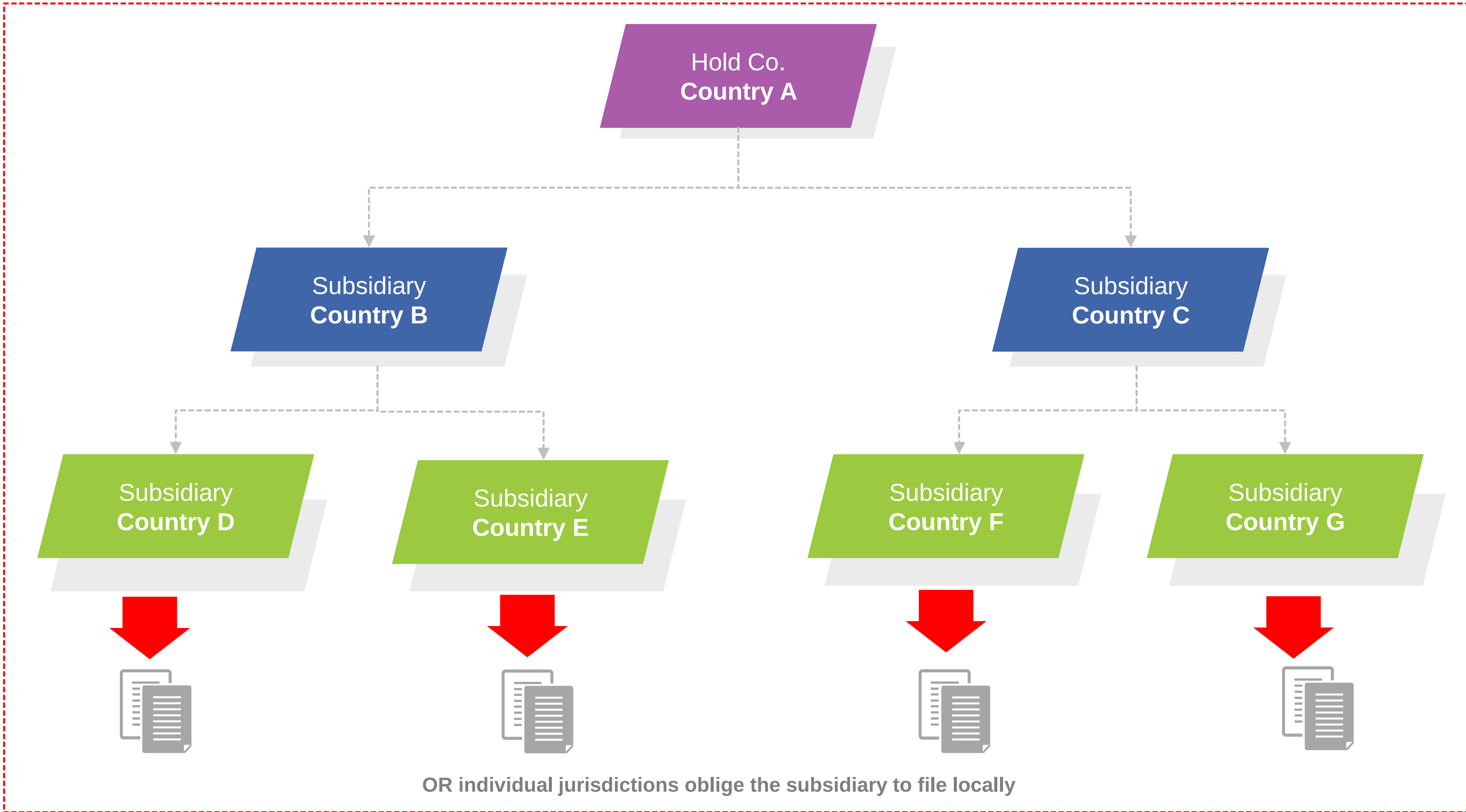
Where a jurisdiction fails to provide CbyC Reports for MNE groups headquartered in their jurisdiction, to another jurisdiction, because:

- It has not required CbyC reporting through domestic legislation; or
- No competent authority agreement has been agreed in a timely manner for the exchange of the CbyC reports; or
- There is a failure to exchange the information in practice.

A secondary mechanism would be accepted as appropriate, through either:

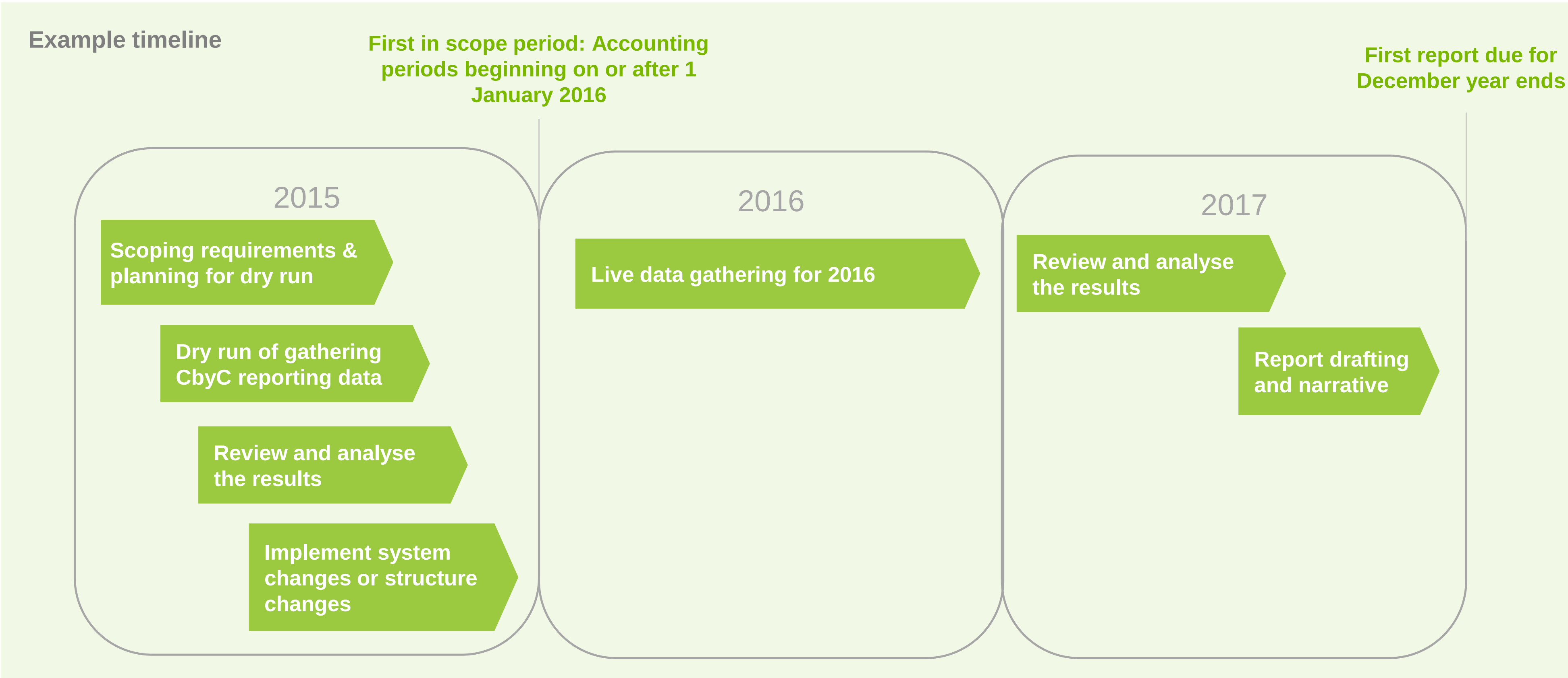
- The receiving jurisdiction requiring a local filing; or
- By moving the obligation for the filing of the CbyC Report to the next tier parent country

Secondary Mechanism

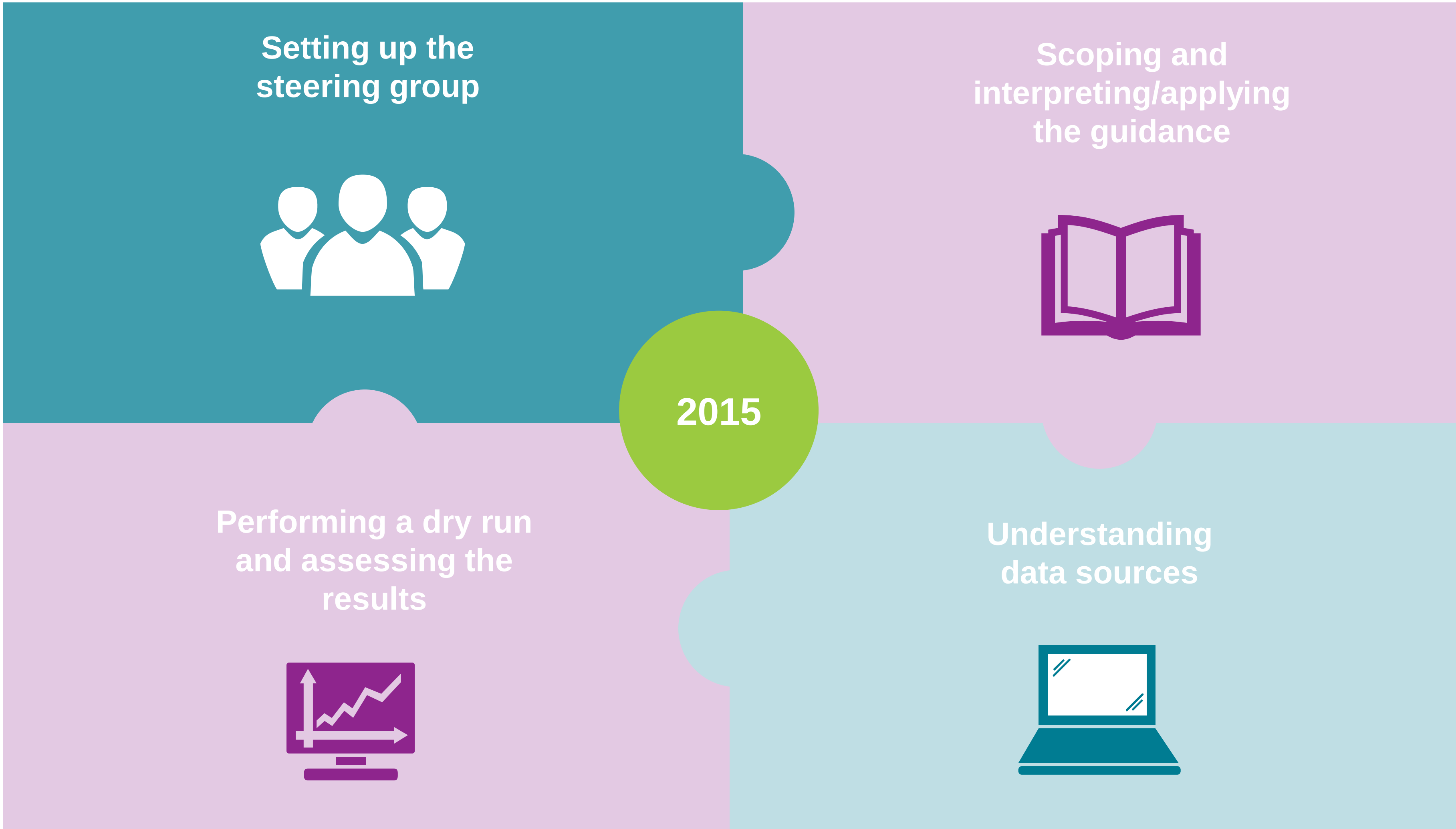


Timing of first submission

- The first CbyC reports would be filed for Multinational Enterprises (MNEs) fiscal years beginning on or after 1 January 2016
- Filing is due 12 months from the end of a financial year. e.g. a company with 31 December 2016 year end will be due to file the CbyC report by 31 December 2017.



How are groups preparing?



Managing communications with the tax authorities

Managing communications with the tax authorities

The potential issue

- Tax authorities will have unprecedented information regarding allocations of profit
- Only Table 3 in the CbyCR template gives the opportunity to explain the split
- Tax authorities may respond differently to this information
- How best to manage?

Managing communications with the tax authorities

The proposed strategy

- Many tax authorities welcome a ‘collaborative relationship’ with tax payers
- Opening dialogue early allows the explanation of value chain and TP policies
- Helps manage notifications to tax authorities where they may be required as part of local anti-avoidance measures
- May be worth considering compiling Masterfile now, as many of the considerations to be discussed would be included

MasterFile and Country File documentation

Master File

High Level overview (group-wide or line of business basis) – and descriptions of:

- The businesses including **drivers of business profit**, **charts on supply chain (for five largest and/or 5% of turnover);** a list of intra-group services; functional analysis; any business restructurings
- Intangibles including the **group's strategy for the development of intangibles**, **a list of material intangibles**, a list of agreements relating to intangibles, any **transfers of intangibles** and TP policies related to R&D and intangibles
- Intercompany financial activity including how group is financed, identification of treasury companies, and TP policies relating to financing
- Financial and tax positions **including unilateral APAs, and other tax rulings relating to the allocation of income**

1 2 3 4

For each jurisdiction

- Description of the **management structure, organizational chart, restructurings, key competitors**
- For each category of controlled transactions,
  - description of material controlled transactions and list of associated enterprises
  - **copies of material intercompany agreements**
  - **intercompany payments for each category by jurisdiction of counter-party**
  - detailed functional analysis including any changes to prior years (can be cross-referenced to Master File)
  - most appropriate TP method & tested party
  - list of comparables and assumptions made
  - reasons for concluding transaction was conducted on arm's length basis
  - a summary of the financial information used in applying the TP methodology
  - **a copy of existing APAs and other tax rulings which are related to the controlled transactions**
- Financial information for local entities, including local financial accounts **and linkages between info used for TP and financial statements.**

Q&A

Thank you ….

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