Publication of final OECD BEPS reports: Implications for the insurance sector in Asia-Pacific

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Executive summary

The Organisation for Economic Co-operation and Development (OECD) has issued final reports on all 15 focus areas in its two-year long project addressing base erosion and profit shifting (BEPS). These reports detail the recommendations developed by OECD and G20 countries for significant changes in key elements of international tax systems, including transfer pricing rules, the deductibility of interest expense, hybrids, the permanent establishment concept, and limitations on tax treaty benefits. Also included are a new country-by-country reporting requirement and a new two-tier approach to transfer pricing documentation. The project broadly looks to ensure that profits are taxed where the economic activities generating the profits are performed and where value is created through amendments to double tax treaties, the Commentary on the OECD Model Tax Convention, transfer pricing guidelines and domestic law.

At the same time, the OECD announced plans for the OECD and G20 countries to work on monitoring the implementation of the BEPS recommendations and to develop a framework for including additional countries in these efforts. Work on some topics such as the multilateral instrument and financial payments will carry on into 2016 and 2017.
Although final reports on the original 15 action points have now been released, work on some topics relevant to insurers, such as the multilateral instrument, interest deductibility and financial transactions, will carry on into 2016 and 2017. The work of insurers, advisors and other interested parties will also need to continue in respect of these areas, and as governments decide whether and how to implement the OECD recommendations.

While many Asia-Pacific jurisdictions are not formal OECD members and, hence, may not implement the complete package, many of these jurisdictions have been engaged in the BEPS project and the BEPS impact will be felt in Asia-Pacific. Even where Asia-Pacific non-OECD members choose not to implement parts of the BEPS proposals, the financing and group structures of Asia-Pacific sub-groups of Australian, US or European insurance groups will undoubtedly be affected by the more likely BEPS related domestic law changes in those parts of the World.

Consideration has been given to how the different Actions might interact should a country decide to implement one or more of the Actions. For example, it has been confirmed that hybrid mismatch rules (Action 2) should be applied before the fixed ratio rule restricting interest deductions (Action 4).

While much of what was released in the final reports was expected, the revisions to the transfer pricing guidelines in respect of risk and non-recognition are concerning. Regarding defining risk and functions, the insurance industry will need to apply both the new guidance and the existing guidance set out in the OECD's Report on the Attribution of Profits to Permanent Establishments (Part IV Insurance) (OECD Part IV). For the non-recognition of transactions, the guidance includes a captive insurance example that has the potential to be construed more widely in regards to intragroup reinsurance arrangements. This guidance could have immediate effect in some tax jurisdictions, and therefore, we strongly recommend that insurers review their transfer pricing documentation. Furthermore, captive insurance is negatively reflected in several other reports, and therefore it will be important to understand whether this stance could be applied to the insurance industry as a whole.

This alert simply sets out the main headlines of the action points most relevant for insurers and is intended as a high level summary of key changes that have taken place.

**Action 1 - Addressing the Tax Challenges of the Digital Economy**

The Action 1 report focuses on the BEPS risks and general challenges of attributing global taxable profit raised by the digital economy. While the final report refers to online payment processes and high speed trading it makes no specific recommendations in respect of financial services. However, the OECD and G20 countries shall continue to give further consideration to this Action in 2016.

**Action 2 - Neutralizing Effects of Hybrid Mismatch Arrangements**

The majority of the recommendations under Action 2 have been known since the initial report was published by the OECD in September 2014. As noted above, the latest report confirms the recommendation that tax jurisdictions should implement a primary rule to deny a deduction for payments which are not taxed in the hands of the recipient, and a secondary rule to tax income from tax jurisdictions which have not implemented the primary rule.

Therefore, it will be particularly important to identify any reliance on hybrids in Asia-Pacific insurance groups (such as intra-group convertibles). This is because even if the jurisdiction where the deduction is sought allows it (say an Asia-Pacific jurisdiction that does not implement Action 2), under the secondary rule the income can be included in the counterparty (which may be in a BEPS-adopting jurisdiction), thereby neutralizing the effect of the hybrid financing of the Asia-Pacific based insurer.

The report also confirms that tax jurisdictions will be free to deal with regulatory capital as they see fit. Where one jurisdiction chooses not to apply the rules to neutralize a hybrid mismatch in respect of a particular hybrid regulatory capital instrument, this does not affect another jurisdiction’s policy choice of whether to apply the rules in respect of the particular instrument.

This, therefore, leaves considerable room for variation between tax jurisdictions. For example, some countries may have, or will, introduce specific domestic law providing for debt deductions on certain layers of regulatory capital while others may not. In the event that specific law is amended in light of Action 2, an element of uncertainty may be reintroduced.

The recommendations also cover structures that provide double deductions and imported mismatches.

The ASEAN financial services hub Singapore (in 2014) recently introduced tax authority guidance on the classification of hybrid instruments, and further changes to domestic law and such guidance may conceivably arise out of the final Action 2 recommendation (including a broader consideration of hybrid entities such as partnerships).
It is worth noting that Action 2 is only concerned with tax mismatches caused by the hybridity of the instrument or entity, and not by differences in tax codes where the income is classified in the same way in both jurisdictions. Accordingly, it would appear that Action 2 recommendations should not, for example, extend as far as mismatches arising from Singapore’s various financial sector tax incentives (that impose a lower rate of tax or an exemption on qualifying financial income) including that for insurance of offshore risks or, in Hong Kong’s case, the categorization of non-source income that is not subject to tax in Hong Kong.

The final report includes more detailed rules than previously, in particular on stock loans and repos, as well as noting that where income is picked up by a CFC inclusion this should not lead to a mismatch.

**Action 3 - Designing Effective Controlled Foreign Company Rules**

The report sets out building blocks for the design of effective CFC rules in order to prevent the diversion of profits of a high-taxed parent to a controlled lower-taxed subsidiary (including the definition of a CFC; exemptions and threshold requirements; the definition, computation and attribution of income; and rules for the prevention and elimination of double taxation) while not always making specific recommendations. It is, therefore, up to individual tax jurisdictions to decide whether to adopt any design elements they do not already have.

The final report removes much of the language on insurance income from the draft report, and now includes a new section outlining factors that could lead to an exclusion of reinsurance income from CFC rules, such as the arm’s length nature of the transaction, benefits from diversification and pooling of risks, the economic capital position of the group, and whether the CFC’s personnel have sufficient expertise to undertake/write the insurance risks. Such insurance-specific wording is welcomed in view of concerns previously raised by the industry.

The recommendations are largely consistent with the Australian and New Zealand CFC rules (which those countries already consider robust) and we understand that there are no plans to make further changes.

It remains to be seen whether there will be changes to CFC codes in other Asia-Pacific jurisdictions (such as Japan and South Korea). Asia-Pacific jurisdictions such as India, Singapore, Hong Kong, Malaysia, Thailand, Vietnam and the Philippines do not have CFC rules and the report – which encourages the strengthening of CFC codes – does not explicitly ask tax jurisdictions without CFC rules to introduce them.

At present, CFC rules have recently been introduced in mainland China and have been proposed as a legislative bill in Taiwan but we understand there are no plans for CFC rules to be introduced in other Asian jurisdictions.

What is perhaps more likely is that changes may be introduced to existing CFC rules in OECD member states elsewhere in the World that affect potential CFC taxable profits located in lower-taxed Asia-Pacific based subsidiaries (such as in Singapore and Hong Kong).

**Action 4 - Limiting Base Erosion Involving Interest Deductions and Other Financial Payments**

Action 4 makes recommendations regarding best practices in the design of rules to prevent base erosion through the use of interest expense, fleshing out a lot of the detail in the earlier discussion draft.

The report recognizes that particular features of the banking and insurance industries mean that the recommended fixed ratio rule and the group ratio rules for interest deductibility set out in this report are unlikely to be effective in addressing BEPS involving interest in these sectors. As such, further work will be conducted, to be completed in 2016, to identify targeted rules to deal with the BEPS risks posed by banks and insurance companies.

The report notes that jurisdictions may consider excluding entities in groups operating in the insurance sector from the scope of the fixed ratio and group rules, in which case they should introduce targeted rules addressing BEPS in these sectors. However, it notes that any such exclusion should not apply to a number of specific entities, including captive insurance companies.

The report also highlights that it is crucial that any recommended interest limitation rules do not conflict with, or reduce the effectiveness of, capital regulation intended to reduce the risk of a future financial crisis.

The rules provide plenty of flexibility which may be intended to allow jurisdictions that already restrict interest deductions on the basis of ratios not to make significant changes.

It is worth noting in this regard that Singapore and Hong Kong already restrict interest deductibility using an interest allocation rule, i.e. interest is not deductible if it is not used in the production of taxable income such as where it funds exempt dividends on equities.
Jurisdictions in the region also take a different approach from a transfer pricing perspective; Singapore, Australia and other jurisdictions in the region currently restrict interest deductions with reference to a statutory general arm’s length test (with supporting guidelines published by the tax authorities), while Australia also supplements the arm’s length rule with a statutory ratio test. In the case of Hong Kong there is no statutory rule, merely IRD ‘arm’s length’ guidelines.

The report specifically allows jurisdictions to keep the arm’s length test and only to apply ratio tests as a ceiling for interest deductions. It is quite possible that Asia-Pacific jurisdictions will keep their arm’s length tests unchanged; the key question is whether jurisdictions will expand their existing provisions or guidance to introduce some of the key OECD recommendations below:

- Net interest should be restricted to a fixed ratio of EBITDA in a corridor of 10%-30%. In exceptional circumstances, tax jurisdictions can use a ratio based on EBIT or assets instead. EBITDA should exclude exempt income such as exempt dividends and foreign branch profits.

- Countries may also, but do not have to, have a worldwide group ratio rule that allows companies to deduct interest up to a ratio calculated from their group’s net interest to its EBITDA. In calculating the group ratio, jurisdictions may allow an uplift in net interest of up to 10%. Questions on how to calculate the group ratio for groups that are loss making or contain loss making entities have been deferred to 2016. Where there is no group ratio there should not be improper discrimination between multinational and domestic groups.

- Jurisdictions may supplement the fixed ratio rule and group ratio rule with the following:
  - a de minimis test for entities with low net interest;
  - a public benefit exclusion which applies to third party non-recourse loans with a duration of at least 10 years financing assets with a public benefit, among other restrictions. If this exclusion applies, the ratio calculations for the rest of the group should be adjusted to take out the excluded interest and related earnings; and
  - a rule allowing for the carry forward of disallowed interest; the carry forward of disallowed interest and unused interest capacity; or the carry forward and carry back of disallowed interest.

- Targeted anti-avoidance may be required to prevent structures that circumvent the rules and to deal with additional risks.

- Grandfathering of existing debt is permitted as well as transitional provisions to delay implementation to allow groups to restructure.

- It is recommended that country-specific interest limitation rules (e.g. an arm’s length provision or thin capitalisation rule) should apply before the fixed ratio. However, it is ultimately a decision for the jurisdiction concerned, taking into account the design of its rules and risks they seek to address.

- Limit interest payable to group companies lacking appropriate substance to no more than a risk free rate of return on the funding provided (in conjunction with Actions 8-10 discussed below).

- Withholding tax is still due on disallowed interest.

- The rules will be reviewed not later than 2020.

**Action 5 – Countering Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance**

Action 5 calls for the development of a framework for compulsory spontaneous exchange of information between tax authorities on rulings with respect to preferential regimes that meet specified criteria. For this purpose the OECD has been working on defining categories of rulings as well as a process that will assist in determining which jurisdictions should receive the ruling.

The framework covers six categories of rulings: (i) rulings related to preferential regimes, (ii) cross border unilateral advance pricing arrangements (APAs) or other unilateral transfer pricing rulings, (iii) rulings giving a downward adjustment to profits, (iv) permanent establishment (PE) rulings, (v) conduit rulings and (vi) any other type of ruling where there is a view that the absence of exchange would give rise to BEPS. These developments mean that insurance groups should generally consider their approach to seeking rulings going forward.

Further, in the Asia-Pacific region this Action is particularly relevant for incentive-based tax regimes such as the offshore insurance incentives available in Singapore that enable regional insurance hubs to avail of lower corporate tax rates on certain income insuring or reinsuring offshore risks.

In this regard, the OECD is not objecting to the use of tax incentive as a tool to attract investments. Under the substantial activity requirement, the key is the nexus rule which links preferential tax treatment to actual economic activities. The OECD is focused on ensuring there is a nexus between the income receiving the tax incentive and the core activities contributing to that income. One suggested approach is to use the level of expenditure to gauge substance and activities necessary to earn the income.
So far as Singapore incentives are concerned, the Government had traditionally already applied a substance based approach (minimum headcount requirements, business projections, business expenditure, etc.), such that they are in-principle aligned with the proposals by the OECD. Some refinements may be needed but the recommendations are unlikely to negatively impact Singapore’s regime.

**Action 6 - Preventing the Granting of Treaty Benefits in Inappropriate Circumstances**

Of relevance to life insurers is the Treaty Abuse report. While the report is titled as “Final,” there will be further OECD work specific to investment funds in 2016 and amendments will be made.

With regard to collective investment vehicles (CIVs), the report restates the OECD view that the 2014 Action 6 drafting is suitable for addressing the potential treaty eligibility concerns of CIVs and that it reflects the conclusions of the OECD’s 2010 CIV report. The OECD’s previous Treaty Relief and Compliance Enhancement (TRACE) implementation package is referred to as the solution for implementing certain limitations-on-benefits (LOB) tests in practice. As such, the report has not materially changed with regard to CIVs, and we understand no further work will be performed in this area.

For non-collective investment vehicles the OECD indicates that further work is required in certain areas:

- LOB rules — The US entered into public consultation on their LOB rules in 2015, and the OECD wants to consider whether any resultant changes, to be published in 2016, should be factored into Action 6.
- REITs — Updating the LOB commentary to include specific provisions for REITs that reflect previous OECD work on treaty issues for REITs.
- Pension funds — Updating the OECD Model Tax Convention to include a definition of “recognized pension fund” that qualifies as treaty resident.

The Singapore Ministry of Finance, for example, has welcomed the Action 6 recommendations and considers their treaty network to be largely BEPS compliant insofar as most existing treaties contain PPTs or an LOB. Singapore companies within insurance groups (particularly any SPVs or intermediate holding companies) should be increasingly mindful of their substance in terms of demonstrating beneficial ownership in light of the final recommendations, perhaps even more so when entering into an arrangement with a counterparty in an attractive treaty jurisdiction (such as India).

Asia-Pacific insurance businesses should review their multi-tiered financing structures and funds flows, as now is the opportunity to restructure where necessary in advance of the introduction of new tax treaties or a multilateral instrument.

**Action 7 - Preventing the Artificial Avoidance of Permanent Establishments Status**

The permanent establishment (PE) definition has been widened beyond the traditional authority to “conclude contracts” to include situations under the new drafting where a person “habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification.” This could potentially create multiple PEs where insurers use local sales teams and (dependent) agents to lead the negotiation of contracts with customers.

The section on insurance agents collecting premiums contained in the October 2014 draft has been completely removed and replaced with an acknowledgement by the OECD that it would be inappropriate to treat insurance differently from other types of business.

The report notes that follow-up work will be needed to provide guidance on attribution of profits to the PEs that will result from the changes proposed and this is likely to build on the 2010 Report on the Attribution of Profits to Permanent Establishments. This work is intended to conclude before the end of 2016.

Finally, these proposals only deal with the treaty definition of PEs and so consideration will need to be given to whether the domestic legislation is similarly wide and whether tax jurisdictions will expand their domestic definition. We note that quasi-territorial tax regimes such as Singapore and Hong Kong which are effectively based on the source of income do not incorporate a central domestic law PE concept for taxing income; however the definition of PE remains important in these jurisdictions for the purposes of allocating taxing rights with other jurisdictions pursuant to treaties.
Actions 8 to 10 - Aligning Transfer Pricing Outcomes with Value Creation

The insurance industry was heavily involved in the consultation process on Actions 8 – 10 (specifically in respect of risk and non-recognition) in view of the regulated nature of the insurance industry. The industry emphasized the need to recognize preexisting tailored guidance on the allocation of risk and capital in OECD Part IV.

Positively, a footnote to the OECD’s final report makes specific reference to “insurance businesses” and the need to consider the pre-existing OECD Part IV guidance. However, this comment is made in the context of the need to take account of and make reference to Part IV as appropriate, with the implication that the revised transfer pricing guidelines contained in the final report apply to all industries. This, therefore, implies a higher burden of compliance for insurers and could lead to inconsistent approaches by tax authorities.

The final report also confirmed that further work will be undertaken in 2016 and 2017 on the economically relevant characteristics for determining the arm’s length conditions for “financial transactions.” Based on previous announcements, we understand this will include reinsurance arrangements.

There is much focus on functional analysis particularly in the context of assumption of risk, risk management and the forums within which decision making with respect to risk may be undertaken. This wording could be particularly challenging for companies with low head counts.

The final guidance on non-recognition includes a captive insurance example, which seems to imply that the transaction is commercially irrational since it is not possible to find third-party insurance in the local market. The example goes on to state that either relocation or not insuring may be more realistic alternatives. It is not clear how this example sits with the previous paragraphs, which state a number of times that non-recognition does not necessarily arise simply because the same transaction is not observed between independent parties.

In addition, the guidance refers to consideration of whether the group as a whole is left worse off on a pretax basis as a relevant pointer, which does not appear to be considered in the example. Based on this example, there would seem to be a risk that tax authorities could seek to apply similar arguments to disregard intragroup reinsurance as well as captive insurance arrangements. However, in previous forums, the OECD indicated that it recognizes a distinction between groups with captive insurers and the insurance industry as a whole where risk transfer is the “stock and trade.”

Group synergies are discussed in the report, which may provide insurers with an ability to recognize the benefits of risk pooling.

Overall it is disappointing that some key comments raised by the industry have not been reflected in the final report. It is not clear whether any remaining concerns will be reflected as part of the further work to be performed in 2016 and 2017. In the meantime, it should be noted that the final guidance can be implemented with immediate effect in certain jurisdictions and therefore groups should review their transfer pricing arrangements as soon as possible.

Action 11 - Measuring and Monitoring BEPS

This Action does not have any specific implications – rather it focuses on measuring the general impact of BEPS and the challenges which jurisdictions face in terms of analysing the economic impact of BEPS. It stresses the importance of collection, compilation and analysis of data. Whilst it is largely focused on the tax administration, it does allude to the importance of reporting under Action 13 which would inform the analysis of tax authorities.

Action 12 - Mandatory Disclosure Rules

This Action is aimed at providing a framework that enables jurisdictions without mandatory disclosure rules to introduce rules to gather early information on potentially aggressive or abusive tax planning schemes and their users.

Where these rules have been implemented in domestic law in other jurisdictions (e.g. in the UK), they have had a broad impact on the early disclosure of tax efficient structured finance transactions. Given that the recommendations in this Action do not provide a minimum standard, jurisdictions in the region may or may not introduce such disclosure regimes. The Action sets out recommendations for rules targeting international tax schemes, development and implementation of information exchange and co-operation between tax administrations. Australia is currently considering the costs and benefits of this Action and is proposing a voluntary disclosure code which is currently under review by the Board of Taxation. Overall, it will be interesting to see how tax jurisdictions in the Asia-Pacific region respond to this Action in due course.

Action 13 - Transfer Pricing Documentation and Country by Country Reporting

This Action provides revised standards for transfer pricing documentation and a template for a Country-by-Country Report (CbC Report) requiring multinational enterprises (MNEs) to provide tax authorities with information regarding their entire global footprint. Cbc Reports would be required to be filed by MNEs with financial statement revenue of €750m or greater (Australian has chosen A$1 Billion) and are to be implemented for fiscal years beginning on or after 1 January 2016. The revenue threshold shall be revisited as part of the 2020 review.
It depends on domestic legislation if taxpayers in a particular jurisdiction will be required to submit the master file. However, the first year’s documentation produced will be of paramount importance as it will be the base information that will be available to all tax authorities for subsequent years. The master file, together with the CbC Report data, will highlight any issues in the group’s transfer pricing policy, the potential for new PEs and questions around the location of intangibles as well as any associated functions.

Mainland China and Australia are introducing CbC Reporting regulations and have drafted their rules in a way which allows them to obtain the CBCR from the local entity, if they are unable to do so via their tax treaty or other tax information sharing agreements. Hong Kong has currently not introduced legislation or consulted in this regard. Singapore, which has a similar local/master file in its transfer pricing guidelines, is currently consulting on introducing CbC Reporting provisions.

**Action 14 – Making Dispute Resolution Mechanisms More Effective**

The measures developed under Action 14 aim to strengthen the effectiveness and efficiency of the Mutual Agreement Procedure (‘MAP’) process as outlined in the Article 25 of the OECD Model Tax Convention 2014. Action 14 develops a minimum standard aimed at ensuring that treaty obligations related to MAP are implemented and cases resolved, administrative processes related to resolution of treaty disputes are implemented and taxpayers can access the MAP when eligible.

Further work is being undertaken to develop an assessment methodology to monitor the implementation of this minimum standard.

It is worth noting that Australia, New Zealand and Japan are the only Asia-Pacific jurisdictions which have declared their commitment to provide for binding MAP arbitration in their bilateral treaties.

**Action 15 – Developing a Multilateral instrument to Modify Bilateral Tax Treaties**

This Action provides for an analysis of the tax and public international law issues related to the development of a multilateral instrument to enable jurisdictions that wish to do so to implement measures developed in the course of the work on BEPS and amend bilateral tax treaties. An ad-hoc group has been formed to develop a multilateral instrument and the negotiations will continue until 31 December 2016. The initial conference to negotiate the convention starts on 5 November 2015, under the chairmanship of the UK, supported by vice-chairs from China and the Philippines. Over 90 countries and jurisdictions have indicated they will participate in the negotiations. The participating countries and jurisdictions have been offered a level of flexibility as regards the terms of their participation in the multilateral instruments development and implementation.

Most major Asia-Pacific economies including mainland China, Japan, India, Australia, Singapore and Hong Kong have been involved in the initial discussion on development of the BEPS multilateral instrument and, hence, developments on this Action are quite relevant for Asia-Pacific.

**Summary**

During the past two years, the insurance industry has made considerable efforts to share information with the OECD working parties about insurance business models and the role of risk and capital in insurance.

The final reports released by the OECD reflect that effort, but the work of the insurance industry is far from finished. As we move into the 2016 project, and as governments begin to implement the OECD’s recommendations, the insurance industry will need to continue its knowledge campaign to help ensure that decision-makers are well-informed before making policy decisions that may impact insurers.
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