Foreword

Welcome to the second edition of Global tax points for insurers, a newsletter providing insurance executives with a snapshot of interesting and current developments in the ever-changing world of tax around the globe.

In this issue, we focus on several emerging markets, beginning with India. Here, significant regulatory and market policy developments for insurers need to be viewed against a tax landscape where anti-avoidance rules have been difficult to navigate. The prospect of the proposed dual level Goods and Services Tax (GST) system could be an impediment for insurers operating in the market.

In Indonesia, deliberations continue around technical reserves for unit-linked life insurance. The interpretation of tax law has been a challenge for multinational insurers, highlighting the inconsistencies in the Indonesian tax regime.

Nearby in Malaysia, composite insurance companies are addressing the government’s requirement for splitting life and general businesses – a complex transaction which is made even more difficult by the introduction of GST last year.

Shifting to Latin America, we look at the impact of the new rules for taxing foreign investors in Chile. These investors now have a choice between a system that taxes profits as they are earned, and another as they are distributed – but at a higher rate, which will require some planning considerations.

We next discuss the ongoing debate in the US around what constitutes insurance for tax purposes. A recent court decision has challenged the IRS’ previously narrow interpretation, causing insurers to consider developing policies to cover certain types of business risk which may not previously have been thought to be insurance.

Looking to the future, we explore the impact of digital on insurance through a tax lens, identifying key areas where tax input will be critical.

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

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New legislative policies drive growth and optimism for insurers in India
After a tough course of correction in recent years, the Indian insurance landscape is looking at the future with renewed optimism. Favorable policy action has set in motion a new phase for the industry, which is expected to drive the next era of growth.

A recent and notable regulatory development in India is the foreign direct investment (FDI) limit, which has resulted in positive market sentiment and increased investor confidence. The Union Budget 2016, presented by the Finance Minister of India on 29 February 2016, has promoted FDI in Indian insurance companies (IIC). It removes the requirement of prior government approval for an increase in the FDI from 26% to 49%, subject to “Indian ownership and control” remaining with Indian promoters. Insurance Regulatory and Development Authority of India (IRDA), has also enabled IICs to raise funds in the domestic markets.

Some other noteworthy policy initiatives impacting the insurance industry include:

- Enabling laws for IICs to raise capital through new instruments, including preferred shares and subordinated debt, under IRDA regulatory supervision
- Introducing regulations for foreign reinsurers (other than Lloyd’s of London) to set up branch offices in India
- Issuing an exposure draft for consultation to allow Lloyd’s to enter the Indian reinsurance market
- Permitting Indian insurers to establish businesses outside India and for overseas insurers to set up branch offices in India to transact reinsurance

For tax administration, the government has sought to adopt a non-adversarial and relaxed tax environment free from uncertainty. It aims to reduce litigation by focusing on overhauling the dispute resolution mechanism, which has been favorable for business in India.

On the tax policy front, a consultative approach has been adopted. This has led to an increase in interaction between regulatory authorities and industry participants on issues of tax imminence, including General Anti-Avoidance Rules (GAAR) and indirect transfer tax provisions. Further, in order to meet its commitment to the Base Erosion and Profit Sharing (BEPS) initiative of the Organisation for Economic Co-operation and Development (OECD) and G20, the government has proposed recommendations of Action Plan 1 (taxation of digital economy) and Action Plan 13 (country-by-country reporting) in the Union Budget 2016.

With the fractured indirect tax regime that is prevalent in India today, the consolidated Goods and Services Tax (GST) is expected to contribute to furthering economic growth. The proposal in the budget is to implement a dual GST where tax is applied by both the center and states on every taxable supply of goods and services (central GST and state GST, respectively); an interstate supply of services or goods would be liable to an Integrated GST (IGST). Given this structure, services such as insurance will potentially move to a state GST, which may lead to challenges not only in complying with multiple states’ policies, but also in determining the appropriate GST to be paid in a state on each taxable supply.

The introduction of GST could be a key business change driver for the insurance industry; therefore, it is imperative for insurers to stay informed and prepared to adapt to the changes envisaged under the GST regime. Understanding the impact of GST proposals on business plans, IT systems and internal processes will enable a smooth transition from the old indirect taxation regime to a more efficient operation under the new GST regime.

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Scrutinizing technical reserves for life insurers in Indonesia
Technical reserve adjustments are related to unit-linked instruments, which are a combination of insurance and investment products. Investment income earned by unit-linked instruments is subject to the “final tax regime” which is more favorable to the taxpayer than the “normal tax rate.” Unit-linked instruments are considered insurance products as defined by Otoritas Jasa Keuangan (OJK), the Financial Services Authority of Indonesia.

Under the Indonesian tax law, technical reserves of insurance products for life insurers may be claimed as a tax deduction (changes in reserves running through the income statement), as long as the reserves are calculated by an actuary and approved by the OJK. Life insurers, particularly those with unit-linked products, have taken a tax deduction from increases in technical reserves due to the increased value of unit-linked products, even though most of the assets generating investment income are taxable under the more favorable final tax regime. However, the Director General of Taxation’s interpretation of the current regime suggests that if the technical reserves are tied to unit-linked products, expenses associated with final tax regime income or exempt income are not tax deductible. This is a significant change for insurers, as the interpretation of the tax law is inconsistent in application. Insurers may argue that taxpayers should not be at a disadvantage in applying one of the law principles (i.e., “in dubio contra fiscum”). The uncertainty of the application of law should not justify the tax authority’s adjustment.

The differences in interpretation are primarily driven by fiscal policy objectives:

- Collecting revenue for the state budget
- Expanding the tax base to improve the tax ratio
- Becoming an attractive location for foreign investment

On a local basis, budgetary pressures are a key issue and tax audits provide another source of revenue to fill the budget gap. To quantify that perspective, the 2015 tax budget was increased by 30% and revenue collections from tax audits rose 200%. Some multinational insurance companies received tax assessments denying entire technical reserves, and many are disputing this issue in the Indonesian tax court, which is time-consuming.

Insurers must assess the portion of the technical reserves related to income subject to normal tax (e.g., premium income) and the portion subject to final tax. This presents a challenge internally in ensuring that their accounting and financial reporting systems have the capabilities and flexibility to split the two segments of income, subject to the different tax regimes.

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License split requirements in Malaysia
Legislation has been enacted in Malaysia that requires conventional insurance companies (those offering both life and non-life products) and takaful operators to split their licensing by 2018. From a tax perspective, the potential transfer of business from one insurance or takaful entity to another presents operational challenges, as well as restructuring opportunities.

The Financial Services Act 2013 and the Islamic Financial Services Act 2013 enacted legislation that requires composite insurers and takaful operators to split their licenses by 2018. For example, an insurer that writes both life and general insurance will separate into two legal entities or divest one of its businesses to meet these requirements. This legislation applies to conventional insurers and takaful operators across Malaysia, with the exception of licensed professional reinsurers and retakaful operators.

There are a number of business and tax considerations for insurers and takaful operators to navigate through as they begin the process of a license split. One key consideration is where to house shared services to ensure a tax-efficient arrangement and tax-efficient transfer of employees between entities which could present potential employee retention risks. Other operational issues to consider include:

- Legal impact on the split, such as transfer of existing contacts, licenses and trademarks
- Accounting implications, such as valuation, goodwill, settlement for the consideration of the transfer of insurance business and recognition of distributable reserves
- Changes to business processes, IT requirements and management reporting
- Capital requirements for the individual entities
- Impact to external stakeholders, such as customers, suppliers and regulators

Proper tax planning can help insurers and takaful operators navigate some of the challenges they may encounter when splitting or transferring their businesses. When insurers transfer business, they need to consider income tax, real property gains tax, stamp duty and goods and service tax implications. In addition, there are certain exemptions available that may help reduce some of the tax costs associated with the license split requirements.

Adopting a holistic approach to the issues and potential restructuring options, and having all the stakeholders engaged across operations, finance, tax and regulatory bodies, will ensure a pragmatic, seamless and efficient transition for insurers through the license split.

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Recent income tax changes in Chile affecting foreign investors
In December 2015, the Chilean Congress proposed modifications to the 2014 Tax Reform legislation which may positively impact foreign investors in Chile. These modifications affect the new Corporate Income Tax (CIT) regimes and their applicable tax treatment on dividend distributions to foreign shareholders.

Taxpayers generally have the option to elect one regime during the second half of 2016; each regime has its own modification that needs to be considered closely. As it currently stands, foreign shareholders of entities incorporated in Chile are subject to a total tax burden of 35%. This includes a 24% CIT (for fiscal year 2016), applicable at the level of the profit-generating Chilean company, and a 35% Withholding Tax (WHT) on dividend distributions. It is important to note that CIT is fully creditable against the dividend WHT.

WHT is imposed on dividends that are effectively distributed overseas on a cash basis. Effective 1 January 2017, the Income Tax Law (ITL) will provide two alternative taxation regimes for taxpayers subject to CIT: (1) attributed regime, under which foreign shareholders will be subject to WHT on dividends in the same year in which the income is recognized by the Chilean entity; and (2) partially integrated regime, under which foreign shareholders will be subject to WHT only on effective dividend distributions made by the Chilean company.

Under the attributed regime, taxpayers subject to WHT will be taxed on an accrual basis regardless of the effective distributions made. This system translates to a total tax burden of 35% in the year the company generates the profits, with 25% CIT paid by the Chilean company and 10% effective WHT paid by the shareholder. Shareholders will, however, be permitted to use 100% of the CIT paid by the company as a credit against the WHT due. It must be noted that this regime is not available for a Sociedad Anónima (S.A. or Chilean corporation).

Companies under the partially integrated regime will be subject to a higher CIT rate of 25.5% in 2017 and 27% in 2018. In turn, WHT will only be applicable on effective dividend distributions to foreign shareholders, with 65% of the CIT creditable against the dividend WHT. As a consequence, the partially integrated regime translates to a total taxation of 44.45% on distributed income. In the event foreign taxpayers are resident in a country that has signed a double tax treaty with Chile, total taxation will be 35%.

In addition, modifications were introduced into tax law in February 2016, favoring tax treaty relief for foreign investors. Between fiscal years 2017 and 2020, the total tax burden imposed by the partially integrated regime will be reduced from 44.45% to 35% if the foreign investor is resident in a country subscribed to a tax treaty with Chile, even if the treaty currently is not yet in effect. Foreign investors in Argentina, China, the Czech Republic, Italy, Japan, South Africa and the United States should benefit from such proposals.

Most insurance and reinsurance companies operating in Chile are incorporated as Chilean corporations due to local regulatory rules and should apply the partially integrated regime. This selection would result in a total tax rate upon repatriation of profits of 35% or 44.45%, depending on the tax residency of the Chilean shareholders. Multinational insurance and reinsurance companies with subsidiaries in Chile should review their structures and evaluate potential restructuring alternatives considering, among others, the recently enacted general anti-avoidance rules.

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US tax court decisions: a big win for taxpayers and insurance
A new tax decision is changing the definition of insurance and the way insurers view their risk management strategies. The Internal Revenue Service (IRS) has long challenged an insurance arrangement involving risk shifting and risk distribution. The US tax court recently rejected the IRS definition of “pure” insurance, creating an opportunity for insurance companies to look to new, innovative products that focus on the business risk exposures of their potential clients.

The IRS recently determined that residual value contracts do not constitute "insurance" for US federal income tax purposes. Thus, within this context, a company selling residual value contracts to leasing companies, manufacturers and financial institutions that lease assets to individuals and businesses is not considered an insurance company. The IRS reached this conclusion based on an interpretation of a three-pronged test that has been in force for a number of years.

The test requires an insurance policy to meet these requirements: the policy must contain pure insurance risk, without an investment risk or business risk. This risk must be shifted from the insurance buyer to the insurance company, which must distribute this risk among all its insureds using the law of large numbers. The transaction must fit the commonly accepted definition of insurance, with actuarially calculated insurance premiums charged by a company that is regulated by federal and state insurance laws.

A recent US tax court ruling clarifies that “business risk” is a proper subject of an insurance contract, as are some elements of investment risk and financial risk. By rejecting the IRS definition of “a pure risk that does not include business for investment risk,” the tax court opens the door for significant planning opportunities in terms of how purchasers of insurance manage their risk. For insurers, the ruling sets the stage to develop new product lines for businesses to better meet their risk management needs.

The overriding decision on the second IRS requirement reinforces the importance of state regulations in determining the tax treatment of an arrangement. What is noteworthy is how much the tax court, in reaching its decision, relied upon the fact that the insurer was regulated as an insurance company by the state regulator and that the residual value insurance was regulated as “insurance” by that regulator.

Moreover, the court also ruled that while a buyer can accomplish the same risk management goal by purchasing a different financial product, a derivative or a swap that does not invalidate the arrangement, it is still considered insurance. This is important because it means buyers of insurance can look to third-party insurers, captive companies and financial products that are not offered by insurance companies. It is a whole new way of thinking for insurance companies and financial institutions that are looking to expand into global and corporate risk management.

There are caveats to consider with regard to interpreting what constitutes “risk” and “insurance” at the state level and foreign jurisdictions like Bermuda, home to many captive facilities. Resolution of these questions and insights into the evolving tax, legal and regulatory landscape requires the assistance of tax advisors.

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1 R.V.I. Guaranty Co., Ltd. Vs. Commissioner
Impact of digital on tax in insurance
The advent of digitized customer platforms, the rise of data analytics and the transformation of back office services have significant implications for insurers. Tax processing and administration processes on a global level are moving beyond digital submission of tax returns to real-time and direct access of taxpaying companies’ general ledgers. The related interplay among the customer, insurer, agent and broker, and the use of data analytics have tax implications multinational insurers need to consider.

**Digital customer platforms**

Over the next few years, the insurance industry will invest significant amounts in building digital customer platforms, for example, smart applications that allow insurers to reach and serve their customers directly, empowering agents and brokers to provide smarter, faster and more efficient service. In other instances, third parties will develop technology that insurers will seek to incorporate into their customer offerings.

The tax function should be involved from the outset: thinking about how to incur this development expenditure efficiently, where to maintain intellectual property and how to allocate it to users. Tax sensitization of the customer interface will be critical in ensuring that relevant tax data (i.e., for customer tax reporting) is collected and tax functionality is up-to-date and accurate.

Tax departments should also review customer platforms that introduce cross-border sales capabilities. In many jurisdictions, the regulatory regime effectively prohibits cross-border selling, while cross-border sales already exist for certain jurisdictions, such as the European Union. Soon, travelers arriving in a new country will be offered travel and accident insurance automatically as their mobile phone logs onto a local network. This raises interesting questions about place of sale for both direct and indirect tax.

**Data analytics**

Many statistics are available, charting the exponential rise in the amount of data held in the cloud. Wide sources of data (e.g., smart watches, telematics in cars, sensors in houses) enable insurers to understand risks and behaviors at a more granular level and make more informed underwriting and customer management decisions.

Viewed through a tax lens, this rise in data brings two assets into play: the data itself, which will grow significantly with an intrinsic value, and analytical skills in the form of smart algorithms and people to manipulate and analyze data. The location, ownership and valuation of these assets are crucial from a tax perspective and need careful analysis within the context of the group’s overall value chain.

**Back office transformation**

Most groups are spending significant amounts to transform back office operations. Digital technology, such as the blockchain distributed ledger concept, will also add to those transformation efforts. The implications of restructured processing architectures need to be considered, as groups move to shared services and centers of excellence. The potential tax consequences to consider include the impact of goods and services taxes or value added taxes on costs shared for cross-border activities.

**Digitization of tax processing and administration**

Smarter processes and the need to extract and analyze tax sensitive data for better quality tax filing are pressing tax departments to reduce their costs and resources. Not surprisingly, they are looking to digital technology or finance transformation to obtain data efficiently from other source systems. There are tactical solutions too, such as robotics, which can repetitively extract and manipulate data including tax reporting for annual filing (financial statement and tax return reporting) thereby freeing up human resources to focus on more value-added activities.

Tax administration is moving rapidly to digitization. Already we are seeing tax authorities in some countries moving beyond digital submission of tax returns to real-time, direct access into taxpayer general ledgers. Tax functions need to monitor these developments closely.

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