Keeping Up with Tax for Insurance

September 2019

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Introduction

Welcome back to the September edition of Keeping Up with Tax for Insurance! It's been an interesting month in the UK with Brexit continuing to dominate the UK political landscape and also much of the capacity of the UK government (including HMRC). We expect further significant developments on this, in the run up to the (current) Brexit deadline of 31st October. You can expect further articles on the tax considerations on Brexit in future editions, as the political landscape becomes clearer.

In the meantime, the tax landscape continues to evolve rapidly. This presents insurers with opportunities to differentiate themselves, for example devising a robust tax strategy or achieve efficiencies from technology, but also brings with it significant challenges in terms of tax risk management. It is now widely accepted that tax is a topic of increasing interest to a range of stakeholders. This scrutiny brings risk for the tax department and managing that risk is a renewed area of focus for many insurance tax teams. We kick off the September edition with an article from Janet and Duygu exploring how you can manage the risks arising from the changing tax transparency landscape, and benchmarking the various approaches on tax transparency across the insurance market.

It is clear that there remains a massive appetite for construction in the UK and many businesses are currently preparing for an office move, which creates a challenge to tax and finance teams given that they do not have to do these things very often. There has also been legislative change in the area of capital allowances and business that it is important to be aware of. Alex and Darren offer insight into the various opportunities available to optimise the UK tax position on capital allowances and business rates when an office move project is on the cards and why it is important to get advice on these things on a timely basis to make the most of these opportunities.

After a consultation process over the last few months, HMRC have now published their revised Life Assurance Manual (LAM). Given the previous version of the LAM was dated 2008, and following the changes to the life tax regime applicable from 1 January 2013, this manual has been a long time coming! Through the course of the consultation, several key matters were considered – in particular where it was suggested HMRC's drafting indicated a change of view, or where there was opportunity for HMRC to confirm their stance on particular topics. Katharine and Lindsay take a closer look at some examples of these matters and how the manual addresses them.

To finish off we have two articles on an international theme, firstly on 19 May 2019, the Swiss public voted to adopt the Federal Act on Tax Reform and AHV Financing ("TRAF"). The key objectives of the reform of the current corporate tax system are to safeguard the long-term tax attractiveness of Switzerland as a business location, promoting international acceptance and guaranteeing sufficient tax revenues. Our Swiss Insurance tax colleagues Dominik, Katya and Charalambos have drafted an article to provide insight on the most relevant measures of the tax reform that are expected to affect insurers/reinsurers and captives.

And last but not least, we conclude with an update from our insurance tax colleagues in the US Joy and Julie on the proposed regulations addressing passive foreign investment companies ("PFICs"). On 10 July 2019, Treasury and the IRS released proposed regulations addressing a number of long-standing questions regarding the proper application of several PFIC provisions and also provide guidance regarding the application of the PFIC active insurance exception which was amended as part of 2017 US tax reform. These provisions are relevant for non-U.S. parented companies which are insurance companies or which have insurance company subsidiaries and also have U.S. shareholders, and we take a closer look at the PFIC Proposed Regulations in this article.

I hope you enjoy the articles that we have put together, and as always please get in touch with me or your PwC team if there is anything that you would like to discuss further.

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How can you manage the risks arising from the changing tax transparency landscape?

Insights from benchmarking tax

Tax is changing. It is no longer a private matter for a tax function, but is a topic of increasing interest to a range of stakeholders including the board, media, NGOs, analysts, tax authorities, employees, and customers. This scrutiny brings risk for the tax department and managing that risk is a renewed area of focus for many insurance tax teams. Understanding how you compare to your peers and the comparative view that a stakeholder would form of your tax affairs can help to assess and manage that risk.

Some recent developments in the tax transparency landscape

Tax strategy: all large insurers will now have published their approach to tax, ensuring that, in line with the latest guidance from HMRC, the strategy states the relevant paragraph of the legislation and a date within the last twelve months to show that the statement is current. But does anyone read tax strategy statements? An academic paper used data analytics to review tax strategies published by US headquartered companies operating in the UK. It highlighted instances where a company, due to its size, should have published a strategy and didn't. It also identified those strategies with very similar 'boiler plate' wording, indicating, according to the authors, poor engagement with the purpose of the legislation. The use of data analytics in reviewing tax disclosures is likely to increase.

Publication of country-by-country data: all large insurers will now have disclosed their country-by-country data privately to tax authorities. There are moves within the EU Parliament for this data to be publicly available and the GRI (an organisation devoted to transparency in global reporting) has issued a consultation paper for a new standard on 'Tax and payments to governments' with a focus on public country-by-country reporting. The GRI Sustainability Reporting Standards are widely adopted global standards for sustainability reporting and many companies state that they are GRI compliant. Internal communication with teams responsible for sustainability reporting is essential. Six companies in the FTSE100 make a voluntary disclosure of a form of country-by-country report, including an insurer. It can be helpful to extract and analyse Total Tax Contribution data to ensure that the focus is on all the taxes that companies pay, for example irrecoverable VAT and insurance premium tax, not just corporation tax.

Release of tax principles: a group of large multinational corporations, branded as 'The B Team' has come together, working with NGOs, investors and tax authorities, to prepare a set of seven principles to guide companies as they develop tax disclosures. Companies have endorsed, engaged with and expressed interest in this company led initiative. It is a vital way for views of companies themselves to be discussed and a global insurer is a named contributor to the initiative.

Investor attention on tax is increasing: Norges Bank Investment Management released a paper setting out their expectations for management in relation to tax. RobecoSAM use effective tax rates as a guide to "indicate overly aggressive tax optimisation, which may represent a potential source of risk for a company". In this context, a coherent explanation of your tax affairs is essential. Understanding how your effective tax rate compares to the average for the global insurance sector and the reasons for any differences can help to inform your disclosures.

How are global insurers responding to these changes?

The tax transparency debate is evolving and some insurers are helping to shape that debate. When developing an approach to tax transparency, it is important to consider whether additional disclosures would create value and who the disclosures are intended for. Four insurers in the FTSE100 have a standalone tax report, representing 22% of all the standalone reports in the FTSE100. To put that into context, there are seven insurers in the FTSE100. This is not a picture restricted to the UK; global insurers in Switzerland, Germany and the Netherlands also have separate tax reports.

Key to developing a response to the tax transparency landscape is to understand how you compare to your peers and the comparative view that a stakeholder would form of your tax affairs.

- How does your effective tax rate and cash tax rate compare to the average for the global insurance sector (or selected peers) and what are the reasons for any differences? While the focus on effective tax rates has reduced in recent years, a comparison of your effective tax rate compared to an insurance sub-sector or a named small peer group can provide high level messages for a non-tax expert in the business.
- How do your tax disclosures compare to your peers? If discussing the risks and benefits of tax disclosures internally, benchmarking against peers in the areas of tax strategy, tax governance, tax numbers and performance and the wider impact of tax can be insightful.

How can you manage the risks arising from the changing tax transparency landscape?

Next steps for insurers

Stay ahead of the debate by understanding the current developments in tax transparency and ensuring that key internal stakeholders are briefed e.g. the board and audit committee.

- ETR benchmarking: use our data visualisation tool based on publicly available data to understand how your effective tax rate compares to a global and sector peer group.
- Tax disclosure benchmarking: understand how your tax disclosures compare to your peers based on our most recent review of 2018 annual reports.
- Use these insights to prepare board or audit committee briefing papers on tax transparency.
- Use these insights in a tax transparency workshop to explore the issue of 'tax transparency to whom and for what purpose?' to help develop an informed approach to tax transparency.

For a conversation to gain high-level insights into how you compare to your peers using publicly available information and our data visualisation tools, please speak to your usual PwC contact or contact a Tax Transparency and Benchmarking specialist listed below.

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Capital allowances and business rates

Smooth moves – Using capital allowances and business rates to your advantage on an office move project

With record levels of new UK office space currently in construction and being pre-let, many businesses are currently in the midst of, or are gearing up for, an office move project in the short term. Our Insurance clients are no exception, looking to upgrade their UK property portfolio to meet the demands of a modern workforce. Additionally, many insurers will own investment properties which may need to be refurbished between tenancies. Such one-off projects present unique challenges to internal tax and finance teams, particularly in the area of capital allowances and business rates where there has been recent legislative change.

Where an office move/refurbishment project is being planned, there are opportunities to optimise the UK tax position through:

a) Maximising the UK tax relief available through the capital allowances regime; and

b) Reducing the liability of business rates by utilising the available statutory reliefs and appraising the underlying property valuation.

Key point – Appropriate tax advice at the planning stage of an office move is critical, before legal agreements are entered into and the opportunities to benefit from the optimal tax position are closed off. Optimising the capital allowances and business rates analysis concurrently is an efficient and beneficial approach to such projects.

Office move project – overview

Step 1 – Exit from current premises and lease (including dilapidations and sub-leases)

Step 2 – Agreement of lease for new premises (tenant incentives)

Step 3 – Fit-out of new premises

Step 4 – Ongoing costs and maintenance of new premises

Step 1 – Exit from current premises and lease (including dilapidations and sub-leases)

On exiting a current premises, it is important to consider how the decisions taken from legal, commercial and property perspectives will inform the required tax analysis. If the correct steps are not undertaken or the relevant information is not documented, the available tax relief can be reduced or even foregone.

A multitude of scenarios can take place on exit from an existing premises, each with their own tax complexities. These can include:

- **Tenant undertaking dilapidations works**

Opportunity – Under a fully repairing and insuring lease, the tenant is required to put the premises back into the state it was first leased in, removing the tenant fit-out works. If the tenant chooses to do this work themselves, a detailed capital allowances assessment will be required to quantify and secure the available UK tax relief on these costs.

- **Tenant making a payment to the landlord in respect of dilapidations**

Opportunity – Instead of undertaking the dilapidations works themselves, the tenant can negotiate a one-off payment to the landlord for the landlord to undertake the works instead. Typically a schedule of dilapidations is agreed between the parties and this will inform the tenant's capital allowances analysis of the dilapidations expenditure. Appropriate documentation of the costs incurred is critical to supporting a claim for tax relief.

- **Tenant has made specific provisions for dilapidations during the life of the lease**

Opportunity – Care must be taken to review whether any specific provisions regarding dilapidations were made for accounting purposes and a corresponding tax deduction has been taken previously. Such a treatment would impact on the capital allowances analysis assessing the final dilapidations works/payments on exit from the lease.

- **Tenant sub-leases the property to a third party for the remainder of the lease term**

Opportunity – We have seen many clients opt to sub-lease their existing premises to avoid a costly lease termination payment. Where the property is successfully sub-let, the tenant will need to consider a variety of new tax issues arising, not least that they may be accounting for property income for the first time. If a sub-letting takes some time or does not materialise, there exists an opportunity to minimise the business rates liability based on the occupation status of the property.

Key point – Significant tax relief through capital allowances or revenue deductions may be available in respect of dilapidations payments/works on the exit of a lease. A reduction in business rates may be available if an existing office is left vacant until the end of the lease term.

Capital allowances and business rates

Step 2 – Agreement of lease for new premises (tenant incentives)

On agreement of a new lease over a premises, tenant incentives offered by the landlord can include rent-free periods, cash inducements or capital contributions toward the tenant fit out works. While the first two options have their specific direct tax consequences, where capital contributions are received toward tenant works, the tax outcome will largely be driven by the commercial and legal position negotiated. An incoming tenant should be considering the following issues when agreeing the terms of a landlord contribution:

- Should the contribution be directed toward specific assets or the entire fit-out works? This will impact on the capital allowances available to the tenant, however if the contribution is directed toward assets ineligible for capital allowances, the 'reverse premium' rules may apply such that a part of the contribution may be taxable as income in the hands of the tenant.
- Who will be responsible for undertaking the detailed capital allowances analysis of the works and confirming the tax relief available to both landlord and tenant? If this is not coordinated, it is possible that conflicting tax positions will be taken by each of the parties.
- The new Structures and Buildings Allowances (broadly applying to construction contracts entered into after 29 October 2018) will apply to such landlord contributions. The parties will need to consider which party has the technical entitlement to claim SBA on the fit-out expenditure, based on the legal agreement reached.

Key point – Care should be taken during the lease negotiation phase to ensure that the legal documentation enables the tenant to optimise the tax relief through any tenant incentives received (e.g. landlord contribution toward tenant fit-out works).

Step 3 – Fit-out of new premises

Given the capital expenditure typically involved in the primary fit-out works, the tax relief lavailable through claiming capital allowances is material and is normally reviewed by a specialist capital allowances adviser to:

a) Optimise the quantum of capital allowances availabe; and

b) Identify all enhanced and accelerated tax reliefs (including Enhanced Capital Allowances, Research and Development Allowances, Structures and Buildings Allowances, Short Life Assets).

Given the quantum of tax relief at stake, HMRC expect to receive a detailed capital allowances analysis to support any claim for capital allowances within the tenant's relevant UK tax computations. Protecting your risk position with HMRC through appropriate analysis and disclosure in respect of the fit-out works is a critical element of the project, especially in light of the current UK tax environment.

It is also important to remember that in many circumstances business rates should not be paid during the tenant fit-out period at the full rate. A review of the business rates calculation for the periods affected by the fit-out works should be reviewed in detail to ensure the available reliefs are applied correctly.

Key point – Optimising the tax relief through capital allowances on office fit-out expenditure, including making use of all enhanced/accelerated reliefs, is critical. Further, a business rates reduction should be calculated based on the period the new office is not occupied (during the fit-out phase).

Step 4 – Ongoing costs and maintenance of new premises

Once the new office is fully operational, we typically see businesses repair, reconfigure or expand the premises in the short to medium term. This presents another opportunity to maximise tax relief on the expenditure incurred either through capital allowances, structures and buildings allowances or revenue deductions. For tax purposes, a large percentage of such expenditure is typically revenue in nature and so the accounting classification becomes important in accelerating the available tax relief. Consideration of this point should be dealt with prior to the relevant financial statements being finalised and audited.

As referred to in Step 1, there may also be an opportunity to make a specific accounting provision for dilapidation works during the life of the lease, leading to an acceleration of the associated tax relief. Such planning should be considered in light of the specific facts of the required dilapidation works.

From a business rates perspective, it is important to ensure the correct rateable value is applied to the premises so that business rates paid are based on relevant and supportable data. This is particularly important where the premises are newly constructed by the landlord, given there will be no established rateable value for business rates purposes on initial occupation. Business rates costs are fixed for a number of years based on this valuation, as such it is important this analysis is undertaken thoroughly from the outset.

Key point – Should any ongoing repairs/alterations/ expansions to the new office take place in future, optimisation of the tax relief through capital allowances should be considered. In addition, the rateable value of the office for business rates should be interrogated from the outset of the lease period (particularly if the office is newly constructed) and following any alterations or improvements.

Capital allowances and business rates

Next steps for insurers

As noted above, we recommend that insurers carefully review any planned or recent capital expenditure on properties. Our experience is that there are often opportunities to increase capital allowances claims.

In order to obtain maximum benefit it’s important to ensure that these claims are considered as soon a spossible, in particular as the size of claims can be heavily influenced by the drafting of legal contracts etc prepared at an early stage of the projects.

In addition to capital allowances insurers should reliefs from business rates where there is under-occupation of a building (common on an office move clearly). These reliefs can be represent a valuable cost reduction.

Finally, it is worth reviewing the calculations of business rates, as in our experience rateable values used in these calculations can be incorrect for a range of reasons. Again, this can result in significant costs savings over the life of a lease.

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HMRC publish the new Life Assurance Tax Manual

HMRC have now published the new Life Assurance Manual (LAM) online on GOV.UK following a public consultation period over the last few months. Please see a link to the newly published manual here: https://www.gov.uk/hmrc-internal-manuals/life-assurance

The previous version of the LAM was dated 2008 and clearly this was no longer up to date following the changes to the life tax regime applicable from 1 January 2013. This manual has therefore been a long time coming! Although the new manual is now in force, the old manual is still accessible to taxpayers for reference, and the archived copy has been referred to, with an online link, in the new LAM at chapter LAM01010.

Structure of the manual

HMRC begin the new manual with an introduction to long term business and an overview of the I-E tax regime in the UK, its background and purpose. The manual provides guidance on the corporation tax treatment of insurance companies writing life assurance and other long-term insurance business. There is also a section at LAM01090 that covers life insurance regulation, including the framework of Solvency II, and the role of the PRA and FCA. The introductory chapter at LAM01000 is a welcome addition and serves to contextualise the basis on which life assurance is taxed in the UK.

The manual is spread over a total of 15 chapters and covers the components of the I-E computation, the structure of the trade profit computations as applicable to BLAGAB and non-BLAGAB business, and very helpfully, an example I-E tax computation for HMRC and taxpayers to work through. The remaining chapters cover other matters such as the Long Term Business Fixed Capital computation, Double Tax relief, International and Cross Border business as well as Transfers of Business and Reinsurance.

It is noted that the manual has yet to be updated for the interest restriction and changes to relief for carried forward losses introduced by Finance (No.2) Act 2017. HMRC therefore still have some updates to process. They have stated to the industry that they plan to continue to add to the LAM as appropriate, to ensure it is as complete and as helpful as possible.

Key matters

Through the course of the consultation, several key matters were considered where HMRC's drafting was challenged as indicating a change of view, or where there was opportunity for HMRC to confirm their stance on particular topics. We have taken a look at some examples of these matters and how the manual addresses them in the final version here.

1. **Determining that long-term business is substantially non-BLAGAB**

   Per LAM02040:

   "There is an exception to the general rule providing for a separate BLAGAB business in FA2012/S67 where 'substantially all' of a company's long term business is non-BLAGAB.

   The policy objective is to minimise the compliance burden of producing BLAGAB tax computations for small amounts of BLAGAB business with small amounts of tax at stake.

   There is no set limit for defining 'substantially all'."

   The old LAM had set out a 5% rule of thumb on liabilities but said it was not a 'bright line'. The industry had wanted to ensure that the criteria for this assessment were not too narrow in the new LAM.

   HMRC have now added comment to acknowledge that the criteria are not restricted to any particular kind of measure in order to determine where the amounts of business are **small in absolute terms:**

   "The application of this provision will depend on the facts and circumstances in each case. As a general rule, S67 should be applied where the amounts of business are small in absolute terms. This could be measured in terms of liabilities or investment income and gains potentially accruing. The amounts of tax at stake over the life of the policies should be considered before applying S67".

   HMRC note that LAM02040 is not prescriptive as to the criteria to be used in determining whether long-term business is substantially all non-BLAGAB. In practice, if a taxpayer is nearing any perceived limit, and concerned about this point, it would be reasonable to be discussing that with their Customer Compliance Manager (CCM).

HMRC publish the new Life Assurance Tax Manual

2. **The requirement to consider the allocation history of an asset when determining what proportion of any realised chargeable gain (or allowable loss) is to be attributed to BLAGAB**

   Prior to the re-drafting of the LAM, in February 2013 HMRC published 'Interim Guidance on Allocation Rules'. The Interim Guidance (at paragraphs 46 – 51) covered the allocation of gains when assets are not wholly or partly matched.

   Para 49 of the Interim Guidance stated:

   "It is not envisaged that this rule should require detailed review (or 'archaeology') of the use to which assets might have been considered to have been put in the past, or to aggregate annual allocation percentages relating to each year in which an individual asset was held."

   This is now dealt with by LAM05100. LAM05100 states that:

   "The main difference from the rules for income is that the allocation must fairly reflect the contribution of the asset to BLAGAB over the whole of the period for which it was held by the company, rather than simply reflecting the use of the asset and pattern of business at the time of disposal."

   It goes on further to say:

   "...the methodology applied to establish the BLAGAB-element of the gains or losses may require review of the fact pattern in previous periods to produce a better estimate of the contribution of the asset to BLAGAB (LAM03200)."

   Therefore, LAM05100, in contrast to the Interim Guidance, does not reflect the statement that S101(3) FA 2012 would not require detailed 'archaeology'.

   These tax liabilities are usually policyholder, and assets may be held for very long periods of time – e.g. 20-30 years. Business patterns of BLAGAB/non-BLAGAB can change substantially due to ordinary business patterns of run-off, popularity, and due to changes such as the pension freedoms. All of this would indicate, as it was agreed amongst the industry, that the reasonableness of the approach should have been assessed at the outset and it was widely expected that it is not usually right to revisit this substantially.

   It however remains that LAM50100 is largely unchanged from the original text reviewed prior to challenge by the industry. Therefore HMRC could still feasibly 'look back' into an asset's history in order to be comfortable on the allocation of gains. We await to see how this will be applied in practice.

3. **The change in policy in relation to the deductibility of investment capital allowances in computing BLAGAB trade profits**

   Prior to the introduction of the new life regime set out in Finance Act 2012 it was common ground that there was no bar to the deduction of capital allowances on BLAGAB investment assets within the Notional Case I computation. At that time it was not possible to identify capital and revenue items within this calculation.

   As a consequence of Finance Act 2012, the insurer's financial statements are now the basis for the BLAGAB trade profit calculation. The normal Corporation Tax rules apply, except where there is a specific statutory rule that modifies these rules. Capital allowances are not allowable on circulating assets. So HMRC are of the view that there is no statutory provision that modifies the BLAGAB trade profit to allow the capital allowances on investment assets to be deductible.

   HMRC does acknowledge that, although this position is a natural consequence of the Finance Act 2012 changes, the prevailing practice in the industry was to deduct these capital allowances and this was not historically challenged by HMRC.

   HMRC have now clearly set out their view on the deductibility of these allowances within LAM07510. However, HMRC have stated that they will not seek to challenge capital allowances claims that were previously submitted for accounting periods ending prior to 31 December 2018.

HMRC publish the new Life Assurance Tax Manual

4. **Application of DPT to Life Assurance companies**

   HMRC have taken the opportunity to add a smaller section to the LAM on the application of DPT to life assurance companies. They state at LAM12300 that there are no special diverted profits tax provisions for life insurance companies, but they do call out references in the DPT manual where insurance examples are presented, in particular intragroup reinsurance and offshore bonds. In the current environment where often substantial work is being performed on Brexit projects, this should not be ignored.

5. **The deductibility of Part VII transfer costs**

   HMRC have taken the opportunity to add a comment in relation to the deductibility of Part VII transfer costs for the published manual. There had not historically been such a comment in the old LAM.

   LAM 131000 states:

   "In general many expenses incurred in connection with the acquisition or sale of a business are likely to be capital expenditure. It will also be the case that some of the costs incurred in connection with the transfer of an insurance business under Part VII of the Financial Services and Markets Act 2000 may also be capital in nature."

   Clearly in relation to each Part VII transfer an analysis will need to be undertaken as to whether any of the costs are capital rather than revenue.

In conclusion, a new LAM had been a long time coming, and it is a great achievement for HMRC to have now been able to publish a manual for all to use and refer to, reflective of the post 2013 regime.

The manual includes several helpful examples throughout and this should serve as a great reference for HMRC and taxpayers alike.

Next steps for insurers

UK based Life insurers should review the new LAM.

In particular, we recommend that all life insurers review whether the key points listed out above may impact in their circumstances. Where these may be relevant, careful consideration should be given HMRC's opinion set out in the LAM, and individual insurers may consider engaging with HMRC where they consider either the position remains uncertain or of course they disagree with HMRC's interpretation of these rules.

Otherwise, as noted above, we do consider the revised LAM will serve as a useful reference guide for life insurers, giving useful clarity on a range of complex issues.

Clearly, this LAM is specific to life insurance groups, but we've also seen HMRC changes to other relevant manuals recently (e.g. the GIM, and IPTM). Watch this space for further articles on these revised manuals in future editions.

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Swiss corporate tax reform and its impact on insurers/reinsurers and captives – Status update

Background

On 19 May 2019, the Swiss public voted to adopt the Federal Act on Tax Reform and AHV Financing ('TRAF'). The tax reform will therefore enter into force on 1 January 2020. It is now up to the cantons, if they have not already done so, to push ahead with the implementation of the provisions of the Swiss Cantonal and Communal Income Tax Harmonisation Act ('ITHA') into their cantonal tax laws.

The key objectives of these reforms are safeguarding the long-term tax attractiveness of Switzerland as a business location, promoting international acceptance and guaranteeing sufficient tax revenues.

Taking into consideration the above developments, it is important for companies to identify the potential impact, if any, the TRAF and ITHA will have on their financial statements and by when (e.g. re-measurement of deferred tax assets or liabilities at newly enacted lower income tax rates). We have firstly discussed the most relevant measures of the tax reform that are expected to affect insurers/reinsurers and captives.

Main measures relevant for Swiss domiciled Insurers/Reinsurers and Captives

Although most of the measures of the TRAF (e.g. patent box, R&D superdeduction, etc.) are not expected to materially affect insurers/reinsurers and captives, the following measures may be relevant:

1. Various cantons have already reduced, or at least announced, to reduce their corporate income tax rates. Companies operating in these cantons need to determine whether a re-measurement of their deferred tax assets and/or liabilities is needed and when this is the case (i.e. per half-year 2019 already, Q3 2019 or year-end 2019).
2. For insurers/reinsurers operating with a holding company structure, it should be considered whether the abolishment of the holding company regime will have an impact on the future taxation of such companies. This would particularly be the case if such holding companies will earn some non-participation related income (i.e. income other than dividend income or capital gains from the disposal of subsidiaries, such as interest income, royalty income or management fee income). In such a case, the effective tax rate applicable to such companies would increase from currently 7.83% to the ordinary income tax rate applicable in the respective canton (expected to be some 12% to 21% depending on the canton). It is also to be analysed in such cases whether insurers/reinsurers could potentially benefit from transitional measures (e.g. step-up for tax purposes).
3. For captives operating with a mixed company structure, careful consideration needs to be given, because the abolition of the mixed company regime is highly likely to impact captives' future effective tax rates. Captives should particularly analyse any potential benefit from transitional measures (e.g. step-up for tax purposes).

Companies affected by the above measures will need to analyse, as soon as possible, what the relevant enactment date for financial reporting purposes is. This is particularly important because the federal measures meanwhile became enacted already whereas in some cantons the enactment process is currently ongoing.

Enactment date considerations

As mentioned above, the federal law changes meanwhile became enacted. However, in our view, in most cases it is more reasonable and supportable for (substantive) enactment to occur once the cantonal law is (substantively) enacted. Such 'one enactment' approach (federal and cantonal at the same time) avoids the volatility of deferred tax balances that might arise from two enactment events, which increases the usefulness of the financial statements to the reader. However, since the Tax Harmonisation Act is already substantively enacted, it will be important to include appropriate disclosure in the accounts on these changes. Applying the above approach, existing deferred tax assets or deferred tax liabilities arising from temporary differences will still be measured at the existing tax rate until the cantonal legislative process is (substantively) complete (i.e. upon the substantive enactment of new tax laws or provisional rules at cantonal level).

Since enactment will be considered to be when the cantonal tax law(s) are (substantively) enacted, the actual date of (substantive) enactment will vary from canton to canton depending on the (substantive) enactment of each individual canton's legislative process.

Swiss corporate tax reform and its impact on insurers/reinsurers and captives – Status update

Cantonal level – Status update

For cantons which have already passed/(substantively) enacted Cantonal law changes in the first half of 2019, accounting impacts were in essence already triggered.

However, since many cantons had not passed cantonal tax law changes at 30 June 2019, no accounting impact was triggered for companies operating in those cantons per half-year 2019. Most of the cantonal processes foresee a cantonal enactment of lower rates in Q3 or Q4. Hence, this point and its financial statements impact will need to be closely monitored.

On 1 September 2019, the voters in the canton of Zurich (with 56% majority) approved the cantonal tax law changes. Consequently, the canton of Zurich will introduce as of 1 January 2020, all the measures that are available based on the framework provided by the new federal tax harmonisation law to their full extent. In addition, the proposed corporate income tax rate reduction with effect as per 1 January 2021 (i.e. one year later) was approved.

The main measures that will affect the insurers/reinsurers as well as captives based in the canton of Zurich are:

- The reduction of the effective income tax rate from currently 21.15% to 19.7% (as of 1 January 2021). In a second step, the effective income tax rate might then even be further reduced to 18.2% as of 1 January 2023, subject to a separate legislative proposal.
- The transitional rules upon change of the status for holding, domiciliary and mixed companies, in particular the introduction of a five year special tax rate of some 1.14%. Alternatively, the step-up per existing practice is available for ten years.

Please contact us if you have any questions about the Swiss Tax Reform and the impact its implementation may have on your company. Your usual PwC tax advisor or one of the Swiss Insurance Tax specialists listed in this newsletter will be happy to help.

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U.S. tax update

On 10 July 2019, Treasury and the IRS released proposed regulations addressing passive foreign investment companies ('PFICs'). The Proposed Regulations address a number of long-standing questions regarding the proper application of several PFIC provisions and also provide guidance regarding the application of the PFIC active insurance exception which was amended as part of 2017 U.S. tax reform. These provisions are relevant for non-U.S. parented companies which are insurance companies or which have insurance company subsidiaries and also have U.S. shareholders.

Background

A foreign corporation is a PFIC if either (i) 75% or more of its gross income is passive income (the 'Income Test') or (ii) the average percentage of its assets which produce (or are held for the production of) passive income is 50% or more (the 'Asset Test'). Passive income includes income such as dividends, interest, rents, royalties, annuities, and gains from the sale of property that gives rise to passive income. Since the large portion of most insurance companies' assets are assets that generate passive income, most non-U.S. insurance companies would fail the Asset Test and would be treated as PFICs absent an exception.

Prior to its amendment in 2017, section 1297 contained an exception commonly referred to as the active insurance exception. The exception provided that passive income did not include any income earned in the active conduct of an insurance business by a corporation predominantly engaged in an insurance business and which would be subject to tax under subchapter L (the provisions of the U.S. tax code relating to insurance companies) if it were a U.S. corporation. In 2017, the active insurance exception was amended such that the exception applies only to income derived in the active conduct of an insurance business by a qualifying insurance corporation ('QIC'). A QIC is defined in the statute as a foreign corporation that (a) would be subject to tax under subchapter L if such corporation were a U.S. corporation and (b) has applicable insurance liabilities which constitute more than 25% of its total assets as reported on its applicable financial statement. Applicable insurance liabilities include loss and loss adjustment expenses and reserves (other than deficiency, contingency, or unearned premium reserves) for life and health insurance risks. An alternate facts and circumstances test is provided for certain foreign corporations which do not satisfy the 25% requirement.

A U.S. shareholder which owns an interest in a PFIC may be subject to a special tax and interest charge with respect to an 'excess distribution' (generally, certain distributions from PFICs and gains from the disposition of an interest in a PFIC). Alternatively, depending on the particular facts and circumstances, a U.S. shareholder may avoid the special tax and interest charge by making an election to be taxed currently either on the shareholder's pro rata share of the PFIC's annual earnings or the unrealised gain (and certain losses) with respect to the PFIC stock, whether or not a distribution has been received by the shareholder. Additionally, U.S. shareholders of PFICs have additional annual U.S. tax reporting requirements on Form 8621, Return by a Shareholder of a Passive Foreign Investment Company or Qualified Electing Fund.

PFIC Proposed Regulations

The Proposed Regulations provide guidance on each of the two prongs of the QIC test as well as guidance on the active conduct test, which all must be satisfied in order for the active insurance exception to apply.

Definition of QIC

As noted above, the statute provides a two-prong test which much be satisfied in order for a tested foreign corporation to be considered a QIC. The Proposed Regulations provide that the first prong of the QIC test is met if more than half of the foreign corporation's business during the taxable year is the issuing of insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies. The Proposed Regulations provide that the second prong of the QIC test is satisfied if either a 25% test or an elective alternative facts and circumstances test is met. Under the 25% test, generally a foreign corporation's applicable insurance liabilities must exceed 25% of its total assets as reported on the corporation's applicable financial statement for the last year ending with or within the taxable year.

If the foreign corporation fails the 25% test, a U.S. shareholder of the foreign corporation may make an election to treat stock in the corporation as stock of a QIC, if: (a) the foreign corporation is predominantly engaged in an insurance business; (b) the foreign corporation's applicable insurance liabilities constitute 10% or more of its total assets; and (c) the failure of the 25% test was due solely to run-off related or rating related circumstances connected to its insurance business. The Proposed Regulations provide guidance as to what facts and circumstances tend to show whether or not the insurance company meets this test. Since application of the alternative facts and circumstances tests requires an election by the shareholder, the Proposed Regulations provide that the foreign corporation must provide a statement to the shareholder that the alternative facts and circumstances tests are met in order for the shareholder to make the election. Accordingly, foreign insurance companies that fail the 25% test but may meet the 10% test need to consider performing analysis so that such a statement may be provided where appropriate.

U.S. tax update

Applicable insurance liabilities

The Proposed Regulations provide that, for purposes of both the 25% test and the 10% test, the amount of applicable insurance liabilities should be determined based on the company's applicable financial statement; however, the applicable insurance liabilities may not exceed the lesser of: (a) the amount shown on the most recent applicable financial statement; (b) the minimum amount required by applicable law or insurance regulation; and (c) the amount shown on the most recent financial statement made on the basis of U.S. GAAP or IFRS. Additionally, rules are provided to ensure that losses are discounted on an economically reasonable basis if the applicable financial statement is not prepared under U.S. GAAP or IFRS.

Active conduct requirement

The second requirement of the active insurance exception is that foreign corporation's income must be derived in the active conduct of an insurance business by the QIC. Generally, an insurance business is any business of issuing insurance and annuity contracts or reinsuring risks underwritten by other insurance companies. Under the Proposed Regulations, an insurance business also includes the investment activities and administrative services required to support (or that are substantially related to) those insurance, annuity, or reinsurance contracts issued or entered into by the QIC. Whether this requirement is satisfied is based on all the facts and circumstances. Generally, the officers and employees of the QIC must carry out substantial managerial and operational activities for a QIC to be considered to actively conduct an insurance business. However, under the Proposed Regulations, unlike in the prior proposed regulations issued in 2015, a QIC's officers and employees are considered to include the officers and employees of certain related entities. The QIC must exercise regular oversight and supervision over the services performed by the related entity's officers and employees for the QIC in order for them to be taken into account. Additionally, the Proposed Regulations provide that at least 50% of the total expenses (excluding ceding commissions) of the QIC must be expenses incurred for insurance activities performed by the company (or by a related party) for the QIC to be considered engaged in the active conduct of an insurance business. This provision may be particularly problematic for those companies that outsource certain parts of their businesses, e.g., the investment function, to unrelated providers.

Look-through rules

The Proposed Regulations provide that a QIC which owns at least 25% of an investment subsidiary may treat the income and assets of that subsidiary as active if the subsidiary's assets and income are included in the QIC's applicable financial statement.

Qualifying domestic insurance corporations

Prior to the issuance of the Proposed Regulations, it was unclear how to treat a domestic insurance company subsidiary of a tested foreign corporation for purposes of determining the PFIC status of the tested foreign corporation. The Proposed Regulations provide that the income and assets of a qualifying domestic insurance corporation ('QDIC') are not treated as passive (the 'QDIC rule'). A QDIC is a U.S. corporation that is subject to tax as an insurance company under subchapter L and is subject to U.S. federal income tax on its net income.

The Proposed Regulations, however, provide that the QDIC rule does not apply to prevent a less than 50% U.S. shareholder in a tested foreign corporation which is determined not to be a PFIC as a result of the QDIC from being treated as owning an interest subsidiaries of the tested foreign corporation which themselves are PFICs. But for the QDIC rule exception, the ownership of the PFIC would not be attributed to the U.S. shareholder as it owns less than 50% of the foreign holding company which is not a PFIC.

Effective dates

As a general matter, the Proposed Regulations apply to taxable years of U.S. persons that are shareholders in certain foreign corporations beginning on or after the date the regulations are finalised. Taxpayers have the option of relying on the Proposed Regulations as if they were final regulations provided they do so consistently and in their entirety.

Comment period

Comments are specifically requested on a number of the provisions. The comment period with respect to the Proposed Regulations closes on 9 September 2019.

Summary

While the Proposed Regulations provide helpful guidance on many items, many aspects of the PFIC active insurance exception remain unclear. These rules also require significant effort and documentation for some foreign corporations as they endeavor to determine PFIC status on an annual basis. Non-U.S. insurance groups should consider whether they desire to submit comments on the Proposed Regulations, what information is required to determine PFIC status, and what, if any, disclosures may be made to shareholders with respect to PFIC status.

U.S. tax update

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