Keeping Up with Tax for Insurance

December 2019

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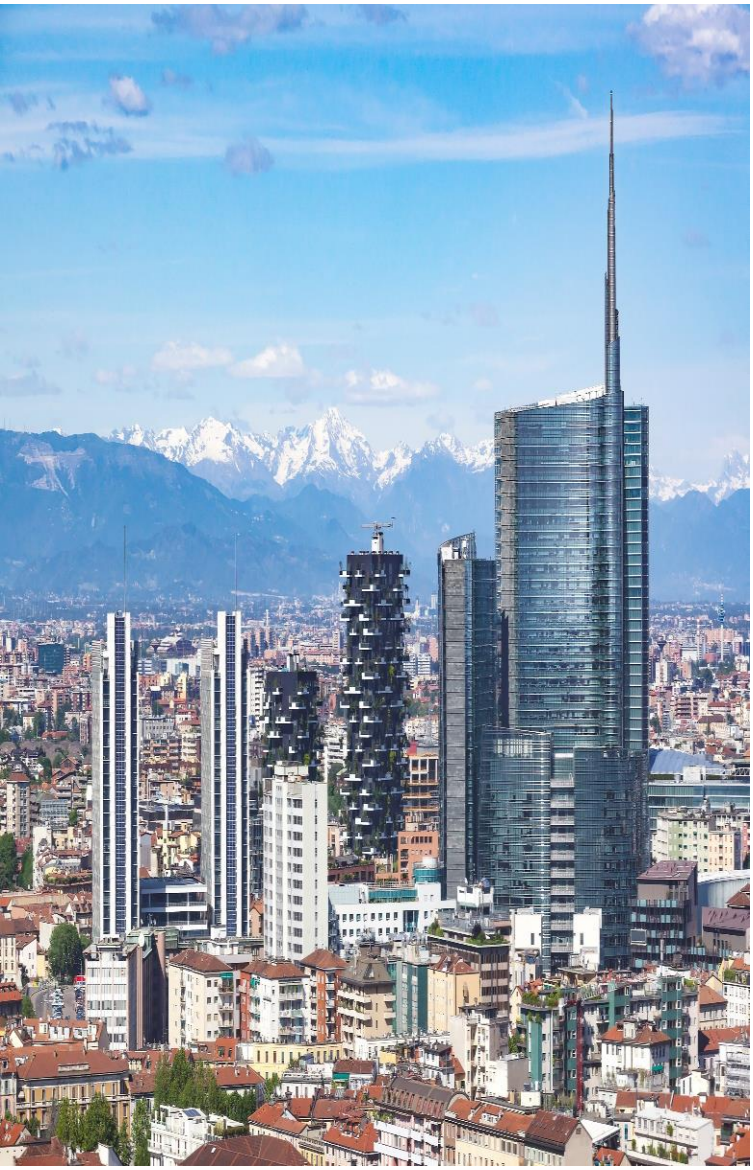
Introduction

Welcome to our December edition of Keeping Up with Tax for Insurance.

It's been another quiet month in the UK of course… We write this shortly after the general election results were released, handing a strong majority to the Conservative party. Whilst we're still assessing the impact of these election results, it's clear this will have significant implications from a policy perspective in the UK.

In the short term, the Government has confirmed that the UK will exit the EU on the 31 January, and will then seek a free trade agreement with the EU over the course of 2020. The terms of this agreement may be critical for insurance groups of course and we'll update on any tax implications from this.



On the tax front, there was a prominent commitment from the Conservatives during the election campaign to leave the corporation tax rate at 19%. Many groups have asked us what this means for year end accounts. In short, until this possible change is enacted groups have to continue to apply existing law in preparing accounts (including the 17% rate change). However, groups may need to consider disclosure of this change when it is formally announced. We can expect a raft of further tax announcements over the next few months and in the run up to a Budget (likely early next year).

Outside of the UK (where tax updates have been limited by the election purdah), we have seen a series of tax announcements of relevance to insurers. In particular, the US Treasury department have (finally!) released the regulations for the base erosion and anti-abuse tax ('BEAT'), a key part of the 'Trump tax reforms'. This will be of particular interest to US parented insurers/reinsurers, and those with substantial US operations.

Additionally, we've seen a number of EU territories (including France and Germany) announcing the implementation of the EU ATAD II rules in advance of the upcoming 2020 deadline, including anti-hybrid and interest restriction measures. Outside of the corporate taxes arena, we've had an updated draft from the EU of their financial transactions tax proposals, which will be of interest to many insurance groups with EU investments.

As usual, we have summarised the headlines from these measures and some steps insurers may wish to take. 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.

Finally, I'd like to wish everyone a very merry Christmas/happy holidays. I hope you all manage to enjoy the break and come back suitably refreshed for what's likely to be another busy year on the tax front!

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Brexit reorganisations – Tax compliance matters

In brief

With Brexit now expected to occur on 31 January 2020 (albeit with a transition period expected thereafter), Insurers will need to ensure they are fully prepared for these changes from a regulatory, operational, finance and tax perspective. Many groups in the Insurance sector have either already implemented their Brexit reorganisation plans or else formulated plans for moving into an appropriate structure to operate post Brexit (if required). This article discusses some of the issues coming out of this that should be considered now as we head towards the corporation tax deadline for those taxpayers with a 31 December year end.

In detail

Deductibility of Brexit related reorganisation costs

Taxpayers in the Insurance sector may well have incurred significant costs in implementing reorganisations or planning for them and the deductibility of such costs will need to be determined, which can require complex analysis.

Where it is considered appropriate to treat a particular cost as deductible, the rationale for this should be documented. We understand that HMRC regard Brexit related restructuring as no different to any other reorganisation and expect taxpayers to undertake appropriate analysis and reflect these conclusions in corporation tax filings. We also understand that HMRC recommend taxpayers provide high level disclosure relating to the deductibility of these costs in their UK corporation tax filings to reduce the need for post-filing engagement.

Principles to consider

As a first step, it is important to determine whether it is appropriate for the entity bearing the costs to be the one bearing them. It may be relevant to consider whether, and to what extent, the entity is benefitting from those costs being incurred. It may also be appropriate to consider whether transfer pricing principles require allocation of costs to other entities within the group.

For trading companies subject to UK corporation tax, under general principles, the key conditions that need to be met for expenditure to be deductible are that they must be:

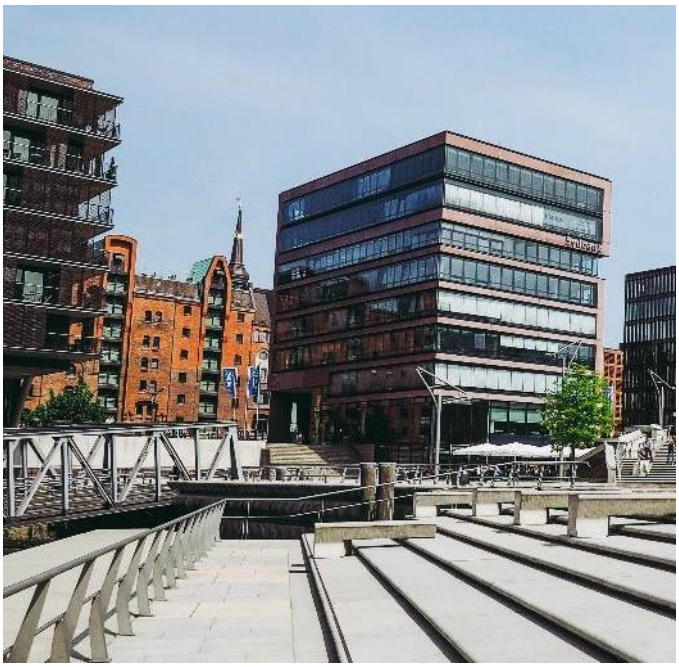
- Incurred by the trading company (whether recharged or otherwise);
- Incurred 'wholly and exclusively' for that trade[1]; and
- 'Revenue' rather than 'capital' in nature[2].

Whether costs are 'wholly and exclusively' incurred for the purpose of a company's trade is a question of fact. The phrase is not defined in statute but has been discussed in case law. In broad terms, it requires consideration of the company's direct and immediate purpose (rather than a remote or underlying purpose). Furthermore, costs may not be seen as deductible if they are for the benefit of another trade/entity.

'Capital' and 'revenue' are also concepts which are not defined in statute. In very broad terms, the relevant case law suggests:

- Where expenses are incurred on the maintenance of a trade or trade rights, they are revenue;
- Where expenses are incurred in relation to the acquisition or improvement of capital assets (whether tangible or intangible), they are of a capital nature.

It may be appropriate for groups to consider how their circumstances compare against the facts and principles in tax cases. One example is *Halifax plc v Davidson* which considered the demutualisation of building societies through a conversion into a bank. In those cases, certain costs were argued to be deductible on the basis that it was necessary to incur them to allow businesses to continue trading effectively. It may be the case that a group considers similarities can be drawn between the need for conversion into banks in those cases and the group's need to restructure in the current Brexit environment to continue trading effectively. However, the aforementioned cases focused on companies incurring costs in the course of adapting a trade rather than splitting businesses or transferring activity, so there are not necessarily clean analogies. Careful analysis based on the specific facts and circumstances will be required.



[1] Otherwise section 54(1)(a) Corporation Tax Act 2009 would preclude the deduction.

[2] Otherwise section 53(1) ibid would preclude the deduction.

Brexit reorganisations – Tax compliance matters (cont'd)

For investment companies, it will be necessary to consider whether costs qualify as expenses of management of a company's business[1]. There is no 'wholly and exclusively' test as there is with trading deductions, but the 'capital' and 'revenue' concepts remain relevant[2]. In broad terms, costs which are incurred by groups in relation to decision-making on how to reorganise in response to Brexit could potentially be viewed as revenue: groups will need to consider how their facts and circumstances allow them to draw on principles in *Camas plc v Atkinson*[3]. For other costs, it may be appropriate to consider what (if anything) can be read across to apply from case law discussing trading income.

Other tax compliance considerations

Although not an exhaustive list, other matters that groups may wish to consider in relation to Brexit reorganisations are highlighted below:

- **UK exit charge disclosure:** Appropriate disclosures relating to any UK exit charges should be included in the corporation tax return computation, as this may help reduce the need for future HMRC clarifications. Any such disclosures should be supported by an appropriate tax valuation.
- **Transfer pricing:** As part of any Brexit reorganisation, it will be necessary to reconsider the existing transfer pricing policies to ensure they are still fit for purpose and refresh them where necessary. Any consequential VAT impacts should also be considered.
- **Changes to group structure:** Changes to the group structure, and migration of business/assets/ employees/activities, could impact the availability of exemptions/application of gateways to controlled foreign companies ('CFCs'). This could also impact the taxation of any overseas branches of UK companies, particularly where the branch exemption election has been made, to ensure the branches continue to comply with the anti-avoidance provisions in place under those rules (which broadly mirror the CFC rules).
- **Tracking of deferred gains:** Previous reorganisations may have involved transferring shares intra group in exchange for Qualifying Corporate Bonds ('QCBs') resulting in any gains on those shares being held over into the new debt and 'frozen' until that debt is extinguished or restructured again (TCGA 1992 s116). Where taxpayers have held over gains attached to QCBs, it will be important to ensure these gains are tracked and subsequently brought into account where those QCBs are impacted by Brexit, or other reorganisation, steps.
- **EU Mandatory Disclosure Regime ('EU MDR'):** Brexit related reorganisations that involve transfers from the UK to an overseas jurisdiction or vice versa from 25 June 2018 may need to reported under the relevant local EU MDR rules (by 31 August 2020 for transactions between 25 June 2018 and 30 June 2020). It is likely that the transactions would be reportable by EU intermediaries (e.g. external advisors). However, the obligation to disclose may fall to taxpayers where there is no such intermediary, or they are subject to legal professional privilege. In any event, companies should track which transactions have been reported as, under certain circumstances, these may need to be disclosed as part of tax return submissions.

[1] Section 1219 CTA 2009

[2] Expenses of a capital nature are not allowed under section 1219(3)(a) except where they are expressly allowed by other statutory provisions (see section 1221).

[3] [2004] STC 860.

Next Steps for Insurers

Clearly, Brexit transactions have often involved (or will often involve) complex restructuring of both the legal and commercial/operating structures of insurers with European market presence. HMRC have clarified that they expect insurers to treat these transactions like any other cross border restructuring, although we do expect some additional pragmatism from HMRC around purpose challenges. Insurers will therefore need to carefully consider the tax treatment of these transactions when filing their CT computations, in particular around deductibility of costs, reinsurance arrangements and valuations of assets transferred.

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U.S. tax update – BEAT regulations have been released

On December 2, 2019, Treasury and the IRS released final regulations (the 'Final Regulations') and new proposed regulations (the 'Proposed Regulations') addressing the base erosion and anti-abuse tax ('BEAT'). BEAT, which requires certain U.S. corporations to pay a minimum tax with respect to deductible payments to non-U.S. related parties, was enacted as part of the 2017 U.S. tax reform act. The Final Regulations largely retain the guidance set forth in the previously released proposed regulations which were issued in December 2018 (the '2018 Proposed Regulations'), with some revisions.

The Final Regulations are effective from 6 December 2019 and apply to tax years ending on or after 17 December 2018. However, taxpayers may apply the Final Regulations in their entirety to tax years beginning after 31 December 2017 and ending before 17 December 2018.

The Proposed Regulations generally apply to tax years beginning on or after the date they are finalized and filed with the Federal Register. Taxpayers may choose to rely on the Proposed Regulations in their entirety for tax years beginning after 31 December 2017.

Public comments on the Proposed Regulations are due by 4 February 2020.

Guidance on Insurance Specific Issues

The 2018 Proposed Regulations were largely silent on a number of issues that impact the treatment of reinsurance transactions for purposes of BEAT. The preamble to the 2018 Proposed Regulations requested comments on issues such as netting of amounts with respect to reinsurance transactions and treatment of claims payments. The preamble to the Final Regulations includes extensive discussion of the comments received with respect to the treatment of amounts paid with respect to reinsurance transactions. The Final Regulations incorporate limited changes overall and with respect to reinsurance transactions.

Netting

The preamble to the 2018 Proposed Regulations noted both Treasury and the IRS are aware certain reinsurance agreements provide for netting of amounts paid to and from a reinsurer under the terms of the agreement. Comments were requested addressing whether a distinction should be made between reinsurance agreements providing for settlement of amounts owed on a net basis from other commercial contracts that provide for netting of items payable by one party against items payable by the other party in determining the net amount to be paid between the parties. A number of comments were received both for and against adopting a netting rule for certain reinsurance arrangements.

The Final Regulations provide the amount of a base erosion payment is determined on a gross basis, except as provided in the BEAT netting rule related to derivatives, and to the extent otherwise permitted by the Code or regulations. This determination is made regardless of any contractual or legal right to make or receive payments on a net basis. For example, the Final Regulations provide that any premium or other consideration paid or accrued by a taxpayer to a foreign related party for any reinsurance payments is not reduced by, or netted against, other amounts owed to the taxpayer from the foreign related party, or by reserve adjustments or other returns.

Claims and other payments to a foreign related party

The 2018 Proposed Regulations did not provide specific rules for payments by a domestic reinsurance company to a foreign related insurance company arising out of reinsurance. However, the preamble to the 2018 Proposed Regulations requested comments. Based on a number of comments received, the Final Regulations exclude claims payments made to a foreign related reinsurer from base erosion payments, provided the policies ultimately insure third-party risks.

Specifically, the Final Regulations provide an exception from base erosion payments for amounts paid by a taxpayer subject to tax under subchapter L to a foreign related party that is a regulated insurance company under a reinsurance contract between the taxpayer and the regulated foreign insurance company for losses incurred and claims and benefits, to the extent that the amounts paid or accrued are properly allocable to amounts required to be paid by the regulated foreign insurance company (or indirectly through another regulated foreign insurance company), pursuant to an insurance, annuity, or reinsurance contract, to a person other than a related party. Any amounts qualifying for the above exception are excluded from both the numerator and the denominator of the base erosion percentage calculation.

Other Amounts Related to Reinsurance Transactions

The preamble to the Final Regulations notes that there is no exception for other amounts paid pursuant such reinsurance arrangements (i.e., the determination of whether such amounts are base erosion payments is based upon the general treatment of the underlying payment). The preamble notes that the Final Regulations declined to adopt the approach suggested in comments that ceding commissions should be broken down into components and not treated as base erosion payments to the extent they reimburse amounts paid to third parties. The Final Regulations confirm that all claims payments other than those excluded from the definition of base erosion payment are included in the denominator of the base erosion percentage calculation.

U.S. tax update – BEAT regulations have been released (cont'd)

Other Highlights

Exception for U.S. Effectively Connected Income ("ECI")

The 2018 Proposed Regulations provided that payments to a foreign related party that are subject to tax as ECI are not base erosion payments. The Final Regulations adopt this exception unchanged.

Exception for Subpart F / GILTI / PFIC Inclusions

Though requested by commenters, the Final Regulations do not include an exception from base erosion payments for an amount paid to a foreign related party which is included by a U.S. taxpayer as subpart F income, global intangible low-taxed income ("GILTI"), or a passive foreign investment company ("PFIC") inclusion.

Conduit Payments

Some comments requested that an exception be granted for transactions where a foreign affiliate acts simply as a middle-man. In these cases, a domestic corporation makes a deductible payment to a foreign related party which then makes corresponding payments to unrelated third parties. The Final Regulations provide no exception for these arrangements, even where the arrangement is required by law or for regulatory purposes.

Services Cost Method ("SCM") Exception

The Final Regulations maintain the exception for the cost portion of payments that meet the requirements for the SCM exception that was provided in the 2018 Proposed Regulations. Comments suggested that the exception should be broadened to apply to other types of payments as well. These comments were not adopted.

Net Operating Losses ("NOLs")

The 2018 Proposed Regulations provided the starting point for determining a BEAT taxpayer's minimum taxable income ("MTI") could be reduced below zero by current year losses but that a deduction for an NOL carryover may reduce taxable income, but not below zero. Commenters suggested that the limitation on NOL carryovers be eliminated. However, the Final Regulations adopt unchanged both the NOL and the current year loss rules.

The Final Regulations also adopt other rules related to NOLs from the 2018 Proposed Regulations, including the rule relating to use of the aggregate group's base erosion percentage in determining the amount of the add back of an NOL deduction and the use of the vintage year base erosion percentage in determining the add back of an NOL deduction.

Alternative Minimum Tax ("AMT") Credits

Generally, a taxpayer's base erosion minimum tax amount ("BEMTA") equals the excess of (1) the applicable tax rate for the year multiplied by the taxpayer's MTI for the tax year over (2) the taxpayer's adjusted regular tax liability for that year. In determining the taxpayer's adjusted regular tax liability for the tax year, credits generally are subtracted from the regular tax liability amount, with certain exceptions (such as the research credit).

To prevent an inappropriate understatement of a taxpayer's adjusted regular tax liability, the 2018 Proposed Regulations provided that credits for overpayment of taxes, and taxes withheld at source, are not subtracted from the taxpayer's regular tax liability because these items relate to U.S. federal income tax paid for the current or previous year. Comments requested that AMT credits be excluded from the calculation of credits that reduce adjusted regular tax liability because they represent income taxes imposed in a previous tax year and are allowed as credits in a subsequent tax year.

Treasury and the IRS agreed with these comments. Accordingly, the Final Regulations provide that AMT credits, like overpayments of taxes, and taxes withheld at source, do not reduce the adjusted regular tax liability for purposes of computing BEMTA.

Foreign Tax Credits ("FTCs")

Comments requested that FTCs, or at least FTCs carried forward from pre-tax reform years, also be excluded from the calculation of credits that reduce the adjusted regular tax liability. The suggested changes were not adopted in the Final Regulations. Therefore, the adjusted regular tax liability continues to be reduced by FTCs and could result in an increased BEAT liability.

U.S. tax update – BEAT regulations have been released (cont'd)

Proposed regulations

The Proposed Regulations provide an election to waive deductions that would otherwise be taken into account as base erosion payments in determining whether a taxpayer is subject to the BEAT.

Comments on the 2018 Proposed Regulations requested that the Final Regulations clarify that allowable deductions that a taxpayer declines to claim on its tax return are not 'allowed' deductions, and, therefore, the foregone deductions are not base erosion tax benefits.

The Proposed Regulations provide that a taxpayer may make an election to forego a deduction, and that those foregone deductions will not be treated as base erosion tax benefits if the taxpayer waives the deduction for all U.S. federal income tax purposes and follows specified procedures. A taxpayer may make the election to waive deductions on its originally filed federal income tax return, on an amended return, or during the course of an examination of the taxpayer's income tax return for the relevant tax year, pursuant to procedures prescribed by the Commissioner. The election may be made annually and once made for a particular year is not binding for future years.

Note that the election provided in the Proposed Regulations applies only with respect to deductions. Insurance companies must determine whether an item is a deduction before it can be waived. For example, reinsurance premiums paid generally are considered reductions in gross income, not deductions.

Treasury and the IRS request comments regarding the election to waive deductions, including the reporting requirements and additional rules necessary to prevent a taxpayer from claiming a waived deduction in a subsequent year.

Next Steps for Insurers

Insurers potentially in scope of these rules should review the changes made in the Final Regulations, in particular in respect of reinsurance arrangements and the netting of payments. On a more positive note, the Final Regulations do clarify that certain claims payments can be exempted from these rules and the changes on waiving deductions in the Proposed Regulations are also generally welcome. Insurers should asses the impact of these changes on their BEAT calculations.

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ATAD II hybrid rules – A practical approach to impact assessment

In brief

On 12 July 2016, the EU formally adopted the Anti-Tax Avoidance Directive ('ATAD'). This included measures to implement the recommendations of BEPS Action 2 on hybrids and focused on mismatch arrangements between EU Member States. It was shortly followed by a subsequent Directive, ATAD II. Although the initial intention for ATAD II was an extension to also target hybrid mismatches between EU Member States and third countries, the Directive also introduces new measures to make the EU's hybrids rules more consistent with the Action 2 recommendations.

This is a particular concern for insurers because of the impact on transactions with counterparties and customers (and related inventory management), including financing arrangements and (potentially) certain reinsurance arrangements. The payment-by-payment analysis required is particularly problematic given the breadth of potentially impacted transactions.

Jurisdiction	
France	Draft legislation released. Rules will apply from 1 January 2020, including reverse hybrid measures.
Germany	Draft legislation released in December 2019. Rules will apply from 1 January 2020. Rules also include new measures on transfer pricing of debt
Ireland	Draft legislation released in October 2019. Rules will apply from 1 January 2020, excluding reverse hybrid measures (which are anticipated to come in from 1 January 2022).
Luxembourg	ATAD II rules will apply from 1 January 2020, including reverse hybrid mismatch measures. If a taxpayer takes the position that the anti-hybrid rules do not apply, the Luxembourg tax authorities can request that the taxpayer provides evidence of treatment of the income/expense in another relevant territory (e.g. tax returns, other tax documents or certificates issued by foreign tax authorities).
Netherlands	Draft legislation released. Hybrid transfers of securities made by financial traders acting in the ordinary course of business have not been excluded. Rules will apply from 1 January 2020, with reverse hybrid rules anticipated to apply from 1 January 2022.

In detail

UK implementation status

The UK has been an early adopter of the BEPS project recommendations and introduced domestic anti-hybrids legislation with effect from 1 January 2017. Further, the UK has committed to adopt the minimum standards required to be implemented by Member States under ATAD II by 1 January 2020.

We have discussed the implementation of these rules and the impact for insurers in a number of previous articles, and given these rules have been in place since 2017 many of the initial concerns have been addressed in consultation with HMRC. HMRC have now released guidance on the anti-hybrid rules. No further changes are expected to these UK rules as a result of the current ATAD proposals.

EU implementation status

Following the implementation of the provisions of ATAD (including those in respect of hybrid mismatches) by 1 January 2019, Member States are required to implement the provisions of ATAD II in respect of third country anti-hybrids by 1 January 2020, with subsequent implementation of reverse hybrid entity rules by 1 January 2022.

There has been a lot of activity in recent months with various Member States releasing legislation to ensure they are compliant with the provisions of ATAD II. While a number of Member States have postponed consideration of the reverse hybrid entity rules for the time being, some Member States (for example, Austria) are pushing ahead with early adoption to make them fully compliant with ATAD II from 1 January 2020 (or 1 January 2019 in respect of Belgium). There are still however a handful of countries which are yet to introduce such rules.

A practical approach to impact assessment

In very broad terms, one might expect territories across the EU to ultimately all have anti-hybrid rules which are at least similar. Accordingly, in determining the potential impacts the rules will have on a group, a good starting point may be to look to issues that have emerged from implementation of the UK rules. Where rules in a particular jurisdiction do not yet exist, given that we have had the UK rules in place for some time now, it would seem to make sense to identify potential issues assuming similar rules to those in the UK are introduced. (However, as noted below, differences between Member States in local implementation are anticipated.)

Based on our experience of working with Financial Services business, the areas listed below should be considered as part of any review:

1. **Branch structures:** Assessment of branch structures, including consideration of deduction/non-inclusion mismatches for deemed branch to head office payments, or double deductions;

ATAD II hybrid rules – A practical approach to impact assessment (cont'd)

2. **Financial Instruments and reinsurance:** Consideration as to whether more complex third party financing transactions such as leasing, repos and stock lending might constitute a 'structured arrangement' due to tax potentially influencing their pricing. (A 'structured arrangement' exists where it is reasonable to suppose a transaction is designed to achieve a hybrid mismatch, or where the economic benefit of such a mismatch is shared between parties.) Similarly, this should be considered for FinRe type arrangements. (N.B. The ATAD does not contain any form of carve out for financial traders generally nor for capital market transactions);
3. **US entities:** Identification of entities which are disregarded for US tax purposes or have made the s953d election, which might mean there are double deduction mismatches due to payments being deductible both locally and for UK tax purposes;
4. **Compliance/Documentation:** Consideration of how to meet the compliance burden, given the rules are anticipated to operate on a payment by payment basis.

The Directive lays down principle based rules and leaves the details of implementation to Member States so they can tailor the key components of the rules to fit their domestic tax systems. This is anticipated to result in a degree of inconsistent implementation between Member States. Areas where there might potentially be such differences between local implementations could include the following:

- The definition of 'associated enterprises'. Generally, enterprises are associated where one (indirectly or directly) holds a 25% or 50% interest in another (the applicable percentage depending on the category of hybridity being considered) or enterprises are consolidated for accounting purposes. Different definitions in Member States may bring less/more parties within the scope of the rules;
- Different concepts of 'acting together'. (The Directive extends the concept of associated enterprises to 'a person who acts together with another person in respect of the voting rights'. This acting together concept is newly introduced in ATAD II and may be defined differently in EU Member States, again potentially broadening the scope of the rules);
- Member States may or may not opt for an exception covering certain intra-group loss absorbing instruments held by banks;
- Differing application of the rules in cases of payees applying a special tax regime e.g. REITs; and
- Member States may introduce different documentation requirements.

It will be important for groups to carefully monitor where there are differences between jurisdictions in relation to the areas listed above.

Experience with the UK rules also suggests that it is helpful to look at third party transactions and related party transactions separately, and to formulate a different approach for each category. Where a group does not knowingly enter into 'structured arrangements', compliance and documentation requirements may be particularly burdensome in the finance services sector.

In view of this, there may be merit in considering the new EU Mandatory Disclosure Rules and ATAD hybrid rules together for third party transactions (as well as potential OECD Pillar II work). This is because there is a degree of commonality between some of the hallmarks in the former and the definition of 'structured arrangements' in the latter.

In particular, Hallmarks B and C of the EU Mandatory Disclosure Rules require consideration of cross border arrangements with various tax sensitive features. Both of these Hallmarks are subject to the main benefit test; i.e. in order to apply, a tax advantage must be the one of the main benefits expected from the arrangement under consideration. In this respect there is a difference with the ATAD hybrid rules, as these do not contain a main benefit test. However, groups may want to approach both sets of rules together by identifying all third party transactions where tax is of significance as a starting point.

Next Steps for Insurers

Insurers should review the impact of these new rules on any relevant cross border arrangements, in particular financing transactions and reinsurance arrangements. Whilst each territory is likely to have nuances in their implementation of these rules, in our experience a high level impact assessment should identify any potentially problematic transactions for further review.

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EU Financial Transaction Tax – latest developments

In brief

Following a meeting of EU finance ministers in March this year, a number of draft proposals have been prepared for the implementation of a European Financial Transaction Tax ('FTT').

We understand that the most recent draft is based broadly on the French FTT model. That said, if the proposal proceeds to implementation, it remains to be seen if local implementation (and local interpretation) will be consistent across the participating Member States.

There have been reports of renewed support, particularly from Germany, to bring an EU FTT into force. However, this has frequently been the case since the tax was first proposed back in 2011. If the intended 1 June 2021 start date is to be achieved, there remain significant areas to be resolved, most notably agreeing a methodology for apportioning revenues from the tax across Member States and the building of appropriate collection and reporting infrastructure.

In detail

How did we get here?

A proposal for an EU FTT was first released back in 2011. However, the contingent of participating Member States struggled to reach agreement on the fundamental principles of the scope of the tax, jurisdictional reach and appropriate exemptions. Recently, consensus has moved to an issuance-based tax and in March of this year at a meeting of EU Finance Ministers a proposal for an EU FTT based on the French FTT model reportedly received wide support.

We understand the proposal is for an issuance-based tax, applying at a minimum rate of 0.2% to financial instruments issued by entities established in the territories of the participating Member States which have a market capitalisation exceeding EUR 1 billion. As with the French FTT, the tax would apply to the acquisition of shares or similar instruments (based on the net daily position) and the tax does not extend to derivatives (although physical settlement of derivatives with in-scope securities would trigger the tax).

The proposal allows for several exemptions, which fall into two broad categories:

1. Those relating to transactions carried out by certain entities e.g. CCPs, CSDs, etc.; and
2. Those relating to certain transaction types, including underwriting, intra-group/restructuring transactions, securities lending and repo transactions, and transactions carried out by financial institutions where pursuing market. making activities ('the market maker exemption').

The current intention is for participating Member States to adopt and publish the necessary laws and provisions by 1 January 2021, with such provisions applying from 1 June 2021.

What does the latest draft include?

The market maker exemption is clearly of critical importance to the banking and capital markets sector. Its changing definition in recent draft EU FTT proposals has generated a lot of discussion in the industry.

The proposal appears to be moving towards a model under which the exemption applies to specific types of activity. This could be contrasted with the Italian FTT under which a regulatory exemption (under the EU Short Selling Regulation) must be held by the financial institution, limiting the application of the relief. Again, this approach within the EU FTT draft of exempting certain activity, rather than institutions that hold a particular status, is more consistent with the French FTT approach.

That said, it will be important to monitor this position: any reversion of the approach back to something defined by reference to EU Regulation, such as the Short Selling Regulation for example, does potentially introduce the risk that Member States overlay a domestic interpretation of the relevant Regulation when transposing the Directive into local law. This could result in different interpretations of the exemption across participating Member States.

Beyond the market maker exemption the same points of interpretation relevant to the French FTT will be relevant to the latest EU FTT proposals. Given many points were ultimately resolved through interpretation by the French tax authorities (or the market), it remains to be seen whether there could be inconsistent application of the regime across Member States in practice. Inconsistencies across Member States could become more acute if certain States move away from the minimum requirements established by the Directive (for example, by implementing a tax rate in excess of the minimum 0.2% prescribed).

Challenges

Beyond the risk of local variation in application, although there now appears to be agreement on the shape of the EU FTT proposal there remain significant challenges which will need to be overcome if we are to see an EU FTT come into force.

The EU FTT has the support of ten Member States: Austria, Belgium, France, Germany, Greece, Italy, Portugal, Slovakia, Slovenia and Spain. Under the enhanced cooperation procedure there must remain a minimum of nine participating Member States wishing to submit a proposal to the EU Council. Therefore, one challenge will be keeping the remaining ten Member States in support long enough to bring the tax into force.

EU Financial Transaction Tax – latest developments (cont'd)

Agreeing a fair and appropriate method for apportioning revenue generated by the tax will be a critical component of this (simply allocating revenues to the relevant issuance jurisdictions would result in the majority of the tax going to the jurisdictions with larger capital markets – e.g. France, Germany, etc.). We understand that discussions on the revenue apportionment model are ongoing, and to date there does not appear to be clear consensus on any particular model.

In addition to the revenue apportionment, there is yet to be a clear plan for the collection mechanism of the tax, or for the reporting infrastructure required. Although not essential for the tax to be legislated, it will obviously be critical to have such mechanisms in place in advance of the tax coming into force.

In summary, it remains to be seen whether this new draft proposal will be implemented by 1 June 2021, or at all. To the extent that support for an EU FTT labours for an extended period, again, we may see Member States implement their own domestic FTT, at least for an interim period. In addition to the French and Italian FTTs already in force, Portugal have ratified a law which includes legislative authorisation to enable the Portuguese Government to introduce an FTT, and the Spanish Socialist Party has proposed an FTT (although it remains to be seen whether they will be able to implement this politically).

Next Steps for Insurers

There reportedly remains a clear desire to bring an EU FTT into force. Whilst the shape of the regime appears to have settled, technical issues and points of interpretation could yet emerge (especially if the proposals proceed to domestic implementation across the Member States). More fundamentally, significant aspects are still to be agreed, namely the revenue apportionment model between participating Member States, and the collection and reporting mechanisms. Implementation in 2021 therefore remains an ambitious timeframe.

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Lloyd's Market 2019 Insights

How better insight can help build the bridge to a profitable future

Following another year of major losses at Lloyd's and alarm at the fact that more than half of syndicates reported a combined ratio of over 100 for the third consecutive year, the Franchise Board's tough line on poorly performing business shows no signs of abating.

Nearly £3 billion of business had been removed by the time Lloyd's announced its year-end results in March 2019. With the scrutiny continuing to intensify, firms are under pressure to rein in on costs, avoid cross-subsidisation of profitable and unprofitable business and pull out of lines that have no prospect of delivering an economic return. Firms could face intervention and possible capital loading if they fail to comply.

Growth requires more than cuts

While improved underwriting discipline is clearly useful, cutting out unprofitable products can only go so far in delivering profitable returns. The stark question facing boards is therefore where is future growth going to come from?

And this question is echoed across the non-life market. Few firms have found a satisfactory answer at a time when margins are being relentlessly squeezed by market comparison sites in personal lines. In the motor and home market, pressure for a strategic rethink has been heightened still further by the Financial Conduct Authority's probe into pricing and tighter controls that could soon follow. Whilst we appear to be seeing an improvement in the rating environment on the commercial side, it is not clear whether it will be enough or if it will last.

All these developments are likely to require significant shifts in the strategy of non-life insurers across the market in how they are managed. The right decisions are only possible with a clear understanding of not just the impact of each potential course of action, but also the risks and uncertainty surrounding these options.

Telling vantage point

As a board member or executive, the difficult choices ahead call for a wider ranging perspective on risk and return. Business planning has often relied on comparatively simple revenue and loss ratio analysis, with some management judgement around this. Broader analyses can provide much deeper insights, drawing on anticipated versus actual experience and the interplay between the various levers of risk and return.

Looking across the entire value creation chain right through from risk selection, pricing, reserving and regulatory capital demands to the resulting financial and economic returns is critical to being able to assess options from many different angles. Realistic projections are key, at a time when past experience is providing a less and less satisfactory guide to future prospects – a clear case in point being the extent to which even big cat events have little more than a ripple effect on prices, rather than the hardening that would once have been expected.

This command of the fundamental drivers of risk and reward, and how they interact should offer insurers a unique vantage point to determine what business is likely to be genuinely profitable, where the emerging opportunities lie and how to make capital work harder. As part of your strategic assessment, you can draw on actuarial input into how to adjust the levers between these fundamentals to optimise risk-adjusted returns.

An important further benefit of this actuarial analysis is supporting the board in understanding and challenging loss ratio views, which Lloyd's now expects as part of business planning. Actuarial input also provides valuable sense checking and support for deal targeting, due diligence and making the business case to investors.

Answering the call

Making the most of strategic insight requires collaboration between the board and operation teams/actuaries, working together at the heart of business planning.

The case for strategic contribution and creative thinking across the insurance market has never been stronger. Making the most of expertise in these areas throughout the insurance business (be that in finance, actuarial or dare we say even tax teams!) will be critical in ensuring that insurers are able to grow sustainably in the current challenging market conditions.

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