KUWT for Insurance

November 2020

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Introduction

Welcome to our November edition of KUWT for Insurance. Clearly as we write this, the challenges of COVID-19 remain significant, with increasing local restrictions continuing to impact all of our day to day lives. We continue to wish you and all significant others well in this difficult period, and we hope you managed nonetheless to enjoy the seasonal events like Halloween and bonfire night in these strange times!

On a much more positive note, we've really enjoyed celebrating Black History Month in October at PwC, which has brought out many of the great initiatives ongoing across insurers to achieve greater diversity and inclusion in our industry. I think this is an absolutely critical issue for us all to reflect on, alongside the many other changes we're seeing in the shape of the future workforce (perhaps accelerated all the more by COVID-19). This is summarised in our Workforce of the Future report published by our People and Organisation practice. Dean Farthing and his team will be happy to discuss if this prompts any immediate queries.

On a related theme, we're seeing an ever increasing focus on Environmental, Social and Governance ('ESG') reporting across both external stakeholders (regulators, NGOs etc) and our insurance clients. PwC, together with the profession and the World Economic Forum, have developed a list of metrics and disclosures that companies can use to improve their ESG reporting. The relevant documents on this are here and here. We have also published a report entitled The State of Climate Tech 2020 which may be of interest and we plan on including articles around ESG in future editions.

Pulling us back to key developments this month, we've now seen the issue of the long promised HM Treasury call for evidence on the possible reforms to the Solvency II regime post Brexit. We've included a summary of the key themes from this document in this edition. Whilst this does not directly mention tax or LACDT, any reforms from this review will certainly impact on tax so worth keeping under review.

On tax and continuing on from our article last month, HMRC released an update of the number of live corporate criminal offence investigations they have open. Between live investigations, current cases under review and cases that have been reviewed and not progressed it looks like up to 64 cases have been looked at in total to date. These investigations span 10 different business sectors, including financial services, oil and gas, construction, labour provision and software development. The number and spread of investigations clearly demonstrate that HMRC intends to actively enforce the legislation across all tax and duty regimes, and across organisations of all shapes and sizes. We expect a particular focus on CJRS compliance and these rules over the next few months, but clearly the FS sector remains a clear focus of HMRC's intended efforts here as well.

Additionally, the Council of the EU announced in October that Anguilla and Barbados will be added to the list of non-cooperative jurisdictions for tax purposes, whilst the Cayman Islands and Oman were removed from the list. From an EU MDR/DAC6 perspective, this has implications for the disclosure of cross-border arrangements where the recipient is resident for tax purposes in a jurisdiction on either the EU's or the OECD's lists of non-cooperative jurisdictions. The main benefit test does not apply to this hallmark and hence purely commercial transactions (including reinsurance) may also be disclosable if it involves one of these territories.

Finally, we'd also like to highlight the latest blogs we have released on tax matter in the insurance sector, including one this month looking at how the tax landscape may change over the coming years. These can be found at https://pwc.blogs.com/tax/.

In this month's edition, we present the following articles to keep you up to date with latest developments:

- **Operational Transfer Pricing**
- **IR35: Back on the agenda - are you ready**
- **Tax governance and risk management**
- **The R&D tax incentives regime - trends and important changes**
- **Solvency II - summary of the call for evidence**
- **Intra-group financing and the OECD financial transactions paper**

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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Operational transfer pricing: Beyond transfer pricing policy and strategy, building sustainable transfer pricing implementation

In the current climate, transfer pricing implementation requires more attention than ever to reduce the risk of errors in tax compliance, tax leakage and disputes. This is no longer solely an issue for finance and tax teams but touches a large number of internal and external stakeholders; from the CFO to non-executive Directors and other business departments, tax authorities, statutory auditors and internal auditors.

For a heavily regulated sector like insurance, the challenges from a transfer pricing implementation perspective have increased given insurers need to comply not only with tax requirements (which themselves are getting more onerous) but also to address regulators' concerns (for example, where transfer pricing flows impact reserving or branch accounting).

Finally, the dynamic M&A environment across the insurance market means that deal-readiness across all aspects of tax - including transfer pricing implementation - can have a valuation impact that is a high multiple of the financial cost of any investment required to optimise or remediate transfer pricing implementation issues.

In response to the increasing external and internal pressure, we are seeing insurance groups focus resources in ensuring their transfer pricing processes/governance, and their transfer pricing implementation framework, provide the necessary transparency, data quality and visibility that enable fact-based decision-making and underpin better transfer pricing risk management.

The remainder of this article provides an overview of: (i) the transfer pricing lifecycle and operational transfer pricing triggers; and (ii) how governance and implementation processes can be improved to satisfy the requirements of all the stakeholders involved.

The transfer pricing lifecycle and operational transfer pricing triggers

Transfer pricing implementation is at the core of the transfer pricing lifecycle. Whilst transfer pricing strategy, policy and documentation are critical, experience shows that failures in execution substantially increase transfer pricing risks. Tax authorities around the globe are becoming more focused on accuracy, transparency and quality of the data used in the transfer pricing calculations, as well as the underlying process and governance followed. In the UK, this has come into sharp focus both through HMRC enquiries and through Profit Diversion Compliance Facility cases. Globally, insurance regulators also look at transfer pricing in cross-border transactions, focusing on the robustness of the transfer pricing implementation governance and underlying processes, cash flows and capital impact.

Insurers should take care that inadequacies in the transfer pricing implementation do not materialise in a lack of transparency in the cost allocations processes (e.g. central cost base and cost centres to be recharged) and in difficulties for segmentation and profitability monitoring (e.g. legal entity, line of business or product level). This is particularly relevant for those insurers operating with extensive branch networks, where extracting data for preparing accurate branch accounts is often cumbersome, and this will particularly affect the preparation of tax returns (on a legal entity lens and on a branch basis). As the number of third-country branches grows post-Brexit, regulators are increasingly focused on the capital impact of branch allocations.

The common issues for many insurance companies include:

- challenges on accuracy of data received from finance in relation to budget and forecast (e.g. when pricing intra-group reinsurance transactions or central cost recharges),
- difficulties in retrieving historical data for local audits (often because data transparency and visibility are opaque),
- difficulties in reconciling data (especially where cost allocations are run regularly - for example, monthly or quarterly),
- reliance on key individuals running manual processes or
- large year end transfer pricing adjustments resulting in tax risks, tax overpayments or penalties.

Our experience is that many, if not all, of these challenges can be successfully addressed through a combination of improvement and optimisation of the people/governance, processes, technology and control aspects of the transfer pricing lifecycle.

What does optimising your transfer pricing implementation mean

To mitigate the risks inherent in transfer pricing implementation and to satisfy the requirements from the various stakeholders, organisations are building comprehensive end to end frameworks supporting the implementation of their transfer pricing policies. For some, this involves wholesale re-work of their transfer pricing systems; for others the opportunity is in fine-tuning or refining existing approaches. In either case, the principal components focus on:

Operational transfer pricing: Beyond transfer pricing policy and strategy, building sustainable transfer pricing implementation (cont'd)

- Designing and optimising transfer pricing processes and workflows holistically across tax, finance, IT and other business areas, incorporating the legal and branch entity lenses into the governance framework. The rationalisation and simplification of the transfer pricing execution is the first step in optimising the transfer pricing implementation;
- Standardising transfer pricing processes, by building business process documentation, with the aim of creating an overall robust control environment;
- Identifying opportunities for automation by implementing transfer pricing engines and analytical tools that enable the automation of data extraction, transfer pricing calculations, intragroup invoicing and so on.

Based on our experience of working with large insurance groups there is a clear benefit for those groups engaged in the journey of optimising their internal transfer pricing governance and implementation processes. These benefits include better management of transfer pricing related risks, increased readiness for tax authority scrutiny, internal cost savings - driven by more efficient internal processes - and enabling data-driven decision making.

Key takeaways

Understanding and managing transfer pricing implementation is not new for most insurance groups, but it is increasing in importance. This is driven by tax authority activity, regulatory scrutiny as well as the broader commercial environment. Together, these are giving many insurance groups the stimulus to think through how transfer pricing implementation can be improved and controlled. To succeed in managing the operational transfer pricing aspects, best practice recommendations are to ensure that:

1. operational transfer pricing pain points are identified both within and outside of tax.
2. develop a coherent response to the various operational transfer pricing pain points, combining people/governance, processes, technology and controls; and
3. comprehensive end to end frameworks are built by designing, optimising and standardising transfer pricing processes, as well as identifying opportunities for automation - whether that is large-scale or tactical.

Insurers have been most successful in upping their game on transfer pricing implementation where the business case for change is well articulated, clearly understood and has buy-in from senior stakeholders. That typically means tax and wider finance teams being prepared to map out their current processes around transfer pricing execution and understand the pain points and risks as well as the quick wins that operational TP will bring to the organisation.

The road to operational transfer pricing improvement may not always be straightforward. But with a clear understanding of where you are starting from, a vision of where you are heading, and a decent map of the organisational environment, the journey for all stakeholders - internal or external - will be smoother, thereby improving the ability to meet everyone's expectations along the way.

Next steps for insurers

Given the ever increasing focus from tax authorities in these areas, we recommend insurers review their implementation of transfer pricing policies as well as documentation and methodologies.

This should start with identifying particular pain points in the operation of these methodologies (both within and outside of tax) and then developing frameworks to address these challenges. We've found these conversations can add great value to insurers in focusing activity on the right areas and managing risks proactively.

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The delayed extension of the IR35 rules for the private sector set to apply from April 2021

In light of the current Covid-19 pandemic the Government announced the delay of the IR35 tax reform by one year. Requests for further delays were rejected and the IR35 legislation has now been enacted in the Finance Act 2020 confirming that, other than for small companies in the private sector[1], the end user will be responsible for determining the deemed employment tax status for certain contractors from April 2021.

What's new?

We already knew that the end users would be responsible for making the IR35 assessments and they would be required to provide a copy of the status determination, and the rationale, to their contractors. The contractor has the right of appeal and if the end user does not respond quickly enough they can be liable for the employer NICs. HMRC has placed greater responsibilities on employers to secure their supply chains, and the IR35 rules will apply to intermediaries and agencies supplying contract labour. Broadly the legislation has remained the same as the draft legislation however there are some key changes:

- The end user must have a UK connection, i.e. UK resident or have a UK permanent establishment
- The conditions for where an intermediary is a company have been widened to include any company from which the contractor has received or has the right to receive a payment
- Contractor appeals must be made before the final payment has been made
- Part payments may be required where a payment is made on or after April 2021 which relates to services provided before and after April 2021
- Confirmation of meeting the small company exemption must be provided in writing if requested

Many businesses told us that the process to identify contractors within their organisations was proving to be a challenge. The new and broader conditions where an intermediary is a company may make it even more difficult for companies to identify the personal service companies ("PSCs") within their labour supply chains.

Who bears the costs?

Most companies (end users) would agree that they do not have the capacity to absorb additional labour costs at this time. Even if the company were to engage their PSC contractors via an agency, a managed service provider or third party supplier, they can expect additional costs to be passed on to them.

To illustrate the financial impact, let's say a contractor was earning £100,000 pa, the cost impact for the end user could be as much as £20,000 pa. Additional costs incurred would include employer NIC (13.8%) and the apprenticeship levy (0.5%). The contractor might seek to increase their rate to offset their own perceived loss of benefits and tax efficiency. The total difference could easily be 20% or more if you add additional costs and charges.

Securing the supply chain when preparing for the new legislation is vital and organisations should have the appropriate contractual protections not only with their direct suppliers but throughout the entire supply chain. This involves reviewing and putting into place contracts that enable them to identify any workers caught by the legislation; ensuring that each party and intermediary knows their obligations in passing on any status determination and dealing appropriately with any status dispute.

The Impact of COVID-19 on your workforce

The pandemic has brought with it a number of challenges and for many of our clients this has resulted in substantial changes to their workforce. Many businesses may be looking at restructuring or considering redundancies, but what does this mean for the contingent worker population?

The working environment changed almost overnight and this widely impacted working arrangements. Many engagements that were previously assessed as inside of IR35 may now need to be reviewed to understand how the current working practices have impacted the previous assessments made. Determinations made last year are most likely going to need to be updated as a result.

The delayed extension of the IR35 rules for the private sector set to apply from April 2021 (cont'd)

For our clients, maintaining labour flexibility and agility, without increasing labour costs disproportionately or compromising on risk, will be key to their business models and ability to retain competitiveness. Moving quickly to a new flexible workforce structure or alternative contingent labour strategy should provide a market advantage and attract the best labour force.

The changes highlighted in this note are complex and impact many areas of a business. Initially many organisations considered that the changes to IR35 could be dealt with by tax and procurement. However, the issues cut across the whole business. HR will clearly be interested in anything with such a significant impact on the labour force. Finance will be interested in any cost implications. There will clearly be systems issues too. Contracts with any intermediaries will need to be carefully reviewed as well as supplier relationships.

[1]Note the small company exemption applies to the end user and not the contractor company

Next steps for insurers - Readiness for April 2021

The environment looks very different to last year and it is evident that insurers are being forced to reconsider their workforce models. In readiness for April 2021, there are some key questions to consider:

1. *Where have you got to with your plans for IR35 compliance?*
2. *What impact has COVID-19 had on your contractor population?*
3. *In light of the pandemic does your contingent worker strategy need to be reviewed?*
4. *Have you considered any contractual changes required?*

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Tax Governance & Risk Management - Post COVID-19

In recent years tax authorities and regulators have become increasingly focused on transparency and the control environment relating to the tax affairs of Insurers and other financial institutions.

This trend is expected to accelerate in a post COVID-19 world where tax authorities will be tasked with addressing unprecedented fiscal deficits as well as addressing ongoing issues with "tax gaps". In this article we explore what this environment will look like and the expectations this will create of firms' governance and risk management arrangements. We highlight the regimes and tools that tax authorities have available to them before outlining how Insurers should respond.

Background

The economic impact of the COVID 19 pandemic is likely to lead to large fiscal deficits caused by the measures that have been introduced to address the economic impact of Covid-19. As a result it is almost inevitable that we will see measures to raise taxes and alongside this there will be continued focus by authorities on organisations paying their fair share of tax and clamping down on all forms of suspected tax evasion, aggressive avoidance and non compliance. Insurers are likely to face extra focus due to the integral role they play in the economy both as taxpayer and in providing key services to their customers.

Taking the UK as an example, against this backdrop and emboldened by:

- New powers in recent years - e.g. the Corporate Criminal Offence;
- Further information such as DAC 6 Mandatory Disclosure requirements across the EU;
- The use of existing rule sets such as the Senior Accounting Officer ("SAO") Regime; and
- The breath of enquiry afforded by the new Business Risk Review ("BRR") Process;

it is likely that HMRC and, increasingly, regulators will be very focused on Insurers and how they manage not just the technical aspects of their tax affairs but also their wider tax related conduct and operational risks.

This will likely result in an increased appetite by the authorities to pursue tax disputes and seek to penalise and fine firms, if they can show that they have engaged in, or facilitated, tax evasion, aggressive avoidance or other forms of non compliance. Tax authorities will also seek, where they deem it necessary, to change industry practices, behaviours, and attitudes towards tax compliance through the more rigorous application of various tax governance and risk management regimes.

What will the environment look like

Looking at what the future environment might look like a number of trends that are likely to characterise the environment emerge:

- Taxpayer's operational capability - Renewed focus on assessing a taxpayer's ability to deliver their tax compliance obligations taking into account the size and complexity of the business and required systems, processes and resources.
- Tax governance & compliance - More scrutiny of taxpayer's behaviours as well as assessing if tax planning supports commercial activity and is not contrary to the intentions of Parliament.
- Firms as gatekeepers of the financial system - Increased pressure on firms to be the gatekeepers of the financial system to take a more involved role in combating tax evasion and aggressive tax avoidance.
- More focus on client tax integrity - More focus on "client tax integrity" with firms needing to demonstrate that they understand the motives of their clients / counterparties, with processes needing to converge to cover not only tax evasion risk but also aggressive tax avoidance.
- More tax disputes - Increased appetite by the authorities to pursue tax disputes and seek to penalise and fine firms who they can show how have engaged in, or facilitated, tax evasion, aggressive avoidance or other forms of non compliance.
- Increased penalties / impact - Increased risk of material financial penalties, reputational damage and regulatory enquiry as well as potential censure for executives under various conduct and accountability regimes such as the UK's Senior Manager and Certification Regime.
- Increased disclosure requirements - Increased tax disclosure requirements are likely, both to tax authorities and publicly. This may include mandatory changes in law (UTP changes and potentially some form of public CbCR), changes to accounting standards and increased pressure for voluntary reporting (e.g. as part of ESG frameworks).

Tax Governance & Risk Management - Post COVID-19 (cont'd)

Expectations of governance and risk management systems will increase

Firms will need to ensure that they address a number of key questions. Firstly in terms of how they manage their own tax affairs. These will include being able to demonstrate that 1) Do we comply, 2) Do we plan responsibly and not aggressively avoid tax, 3) Do we manage tax risks effectively, 4) Do we engage with tax authorities appropriately, and 5) Do we report our risks accurately.

Secondly, in respect of how they interact with other parties the following question will need to be addressed: Can we demonstrate that we take appropriate steps to ensure we don't help others to aggressively avoid tax or facilitate others in evading tax.

Tax Authorities have a variety of tools available to them

Tax authorities have a range of tools available to them to support them in pursuing the tax governance and risk management agenda with rigour and through a number of different lenses. Examples of these include:

- **Focus on overall approach to Governance & Risk Management:**
  - Enhanced Business Risk Review ("BRR") - UK
  - Tax Compliance Management System ("TCMS") - Germany
  - Tax Strategy Disclosures - UK
- **Focus on tax planning, behaviours and interactions with customers, clients and other stakeholders:**
  - Corporate Criminal Offence - UK but with extraterritorial scope
  - EU Mandatory Disclosure Regime ("EU MDR") - Pan EU
  - Directors' Compliance Statement Requirements - Ireland
  - Client Tax Integrity Rules -The Netherlands
  - Increased focus on tax evasion prevention - Luxembourg
- **Focus on processes and system and delivery capability:**
  - Senior Accounting Officer ("SAO") - UK;
  - Uncertain Tax Treatment Disclosures ("UTT") – UK

How should Insurers respond

Given this emerging environment, the importance that Insurers play in the financial system, the increasing role they are expected to play in combating aggressive tax avoidance and tax evasion, and the increased conduct and operational risks that this gives rise to, Insurers should be looking to ensure that the operating model that they have in place for managing such risk is still effective. Teams managing tax should work to ensure that the mandate, roles and responsibilities, authorities and interactions between key stakeholders from areas such as Finance, Legal, Operational Risk & Financial Crime Compliance as well as the front line businesses are clearly defined, understood and effectively and efficiently designed.

Many firms will have Tax Control Frameworks ("TCFs") and related reasonable procedures in place that seek to identify, assess, control, monitor and mitigate all tax risks. However, our experience of looking at these control frameworks as part of our work on EU MDR compliance has highlighted that whilst many such frameworks are often designed effectively there is a need to gain assurance around the effective operation of those frameworks and the key controls within them. It is increasingly important that regular risk based testing and assurance activities are carried out over key tax processes and controls with the results of such activity reported to and reviewed by appropriate stakeholders with all control deficiencies communicated to those impacted with corrective actions initiated and monitored to resolution.

A key focus should be to "horizon scan" and consider material tax loss events that arise in the market and ensure these are fed into internal risk assessment and mitigation activities. Ensuring there is a robust approach for managing tax risk internally whilst monitoring the external environment should ensure a more holistic consideration of tax risk.

Addressing these areas should ensure the organisation is well placed to deal with the evolving environment, continues to effectively managing the tax risks it faces, as well as assisting in it demonstrating it has taken reasonable care in managing issues that may mitigate the impact of any fines or penalties that could arise a result of a enquiries by the authorities.

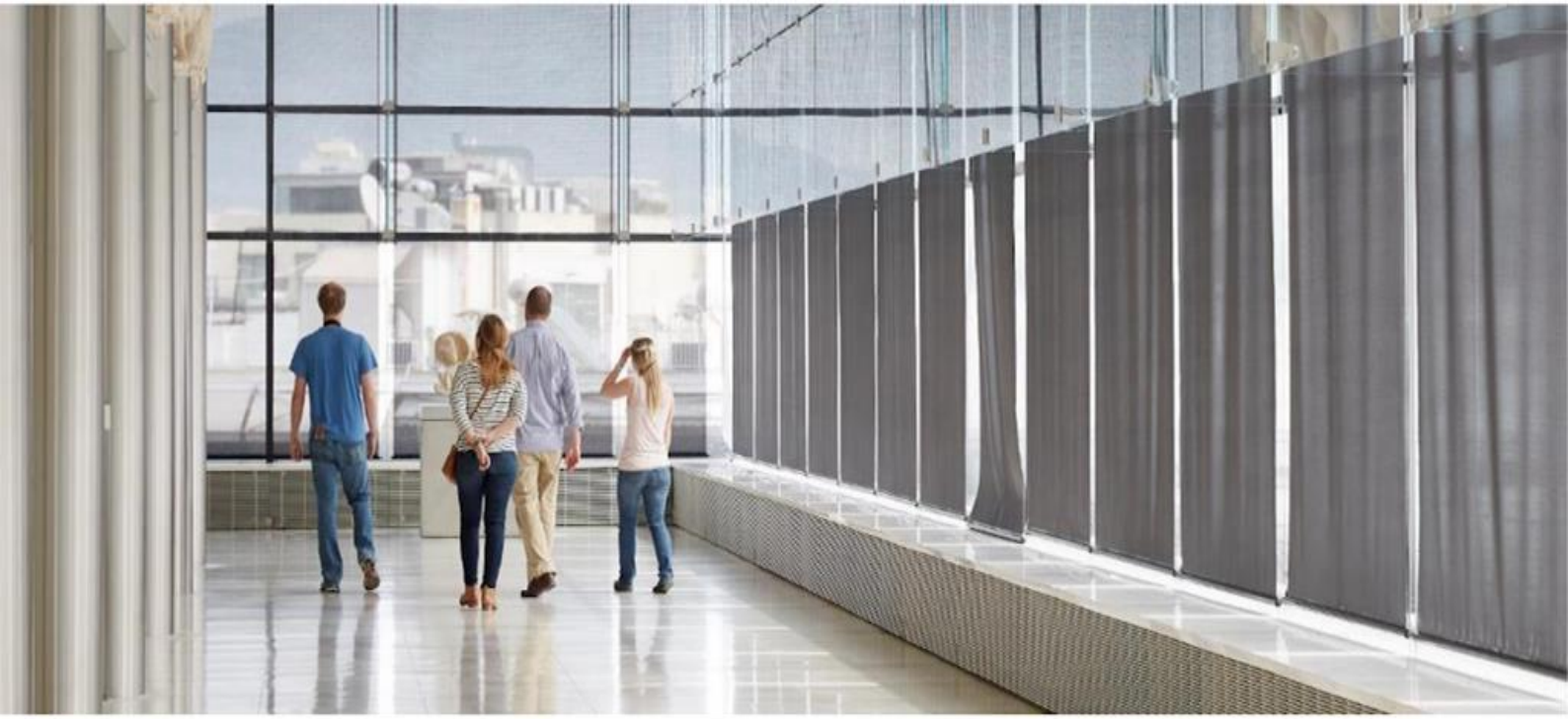
Tax Governance & Risk Management - Post COVID-19 (cont'd)

Next steps for insurers

As governments seek to address large fiscal gaps resulting from the response to the COVID 19 crisis it is inevitable that we will see measures to raise taxes, a focus on organisations paying their fair share of tax and a clamping down on all forms of suspected tax evasion, aggressive avoidance and non compliance. This is likely to impact Insurers given the integral role they play as both taxpayer and intermediary in the wider economy.

Firms should ensure that they continue to have an effective operating model in place for the management of the evolving tax risk environment, ensuring that the mandate, roles and responsibilities, authorities and interactions between key stakeholders across key functional areas and business lines are clearly defined, understood and effectively and efficiently designed. Firms should also be able to demonstrate that their existing tax risk frameworks are not only designed effectively but are also operating effectively through regular risk based testing and assurance activities being carried out over key tax processes and controls.

Taking such actions should reduce the frequency and severity of tax risk events as well as play a key role in Firms being able to demonstrate that they are taking reasonable care in the management of their tax affairs.



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The R&D tax incentives regime – trends and important changes

In September 2020, the UK Government published its latest statistics on R&D tax credits both in respect of the Small and Medium Enterprise ('SME') scheme and Research and Development Expenditure Credit ('RDEC') scheme. The data shows a clear trend: the numbers of claims, the number of claimant companies and the value of R&D expenditure are all going one way: up!

We have summarised below the factors and trends we are seeing in R&D claims and also recent changes to the regime that insurers should be aware of.

Trends in R&D claims

The current expected value of R&D tax relief for 2018-19 is £6.3bn, a more than doubling of the value over the last four years. This trend coincides with the Government's commitment to drive R&D expenditure to 2.4% of GDP by 2027.

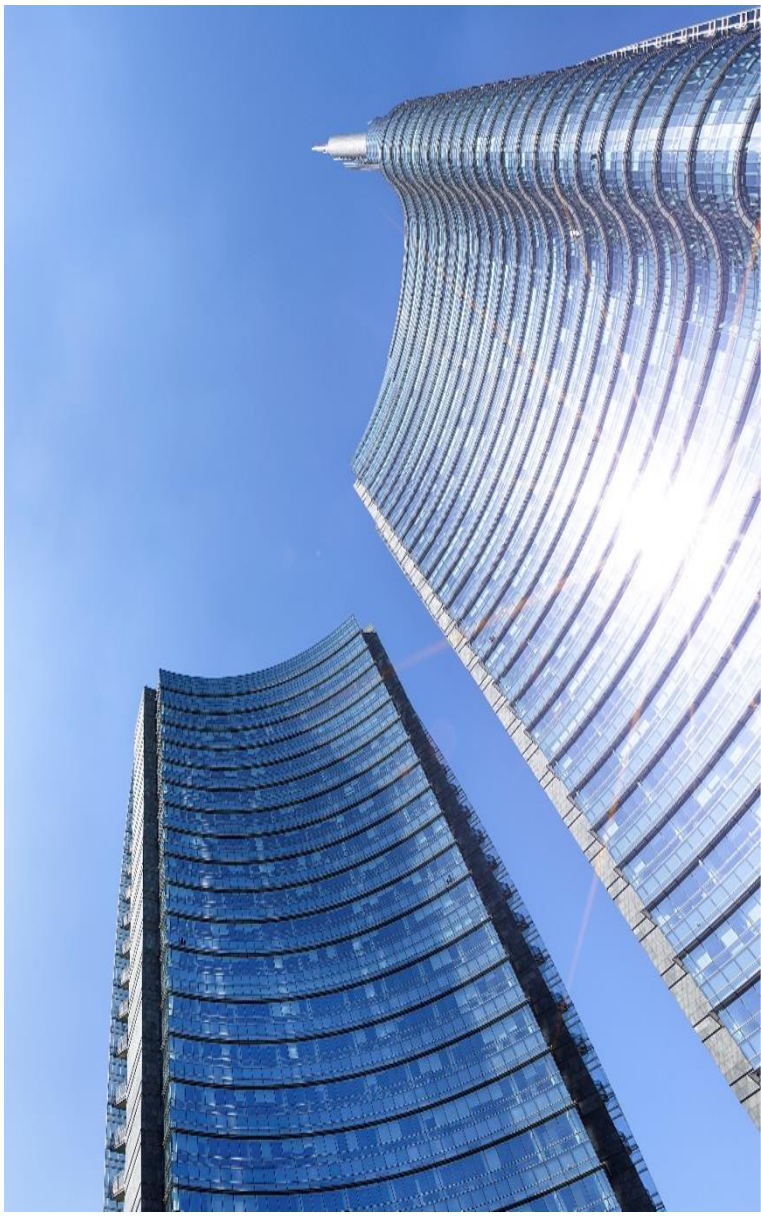
The full year numbers are not available yet for 2018-19, however the statistics show that in 2017-18 the total number of claims for R&D tax credits rose to 62,095, an increase of 17% from the prior year. The increase was primarily driven by a rise in the number of SME claims and RDEC claims made by SME companies, whereas the number of RDEC claims made by large companies has stayed relatively consistent.

The general increase in R&D claims can be attributed to several factors, not least the attractiveness of a real cash benefit to claimant companies. SMEs can receive 33% of their expenditure repaid in the form of repayable tax credits and large companies can claim RDEC at an increased rate of 13% from 1 April 2020.

While it is great to see that so many companies in the UK are investing in R&D, it is important to ensure that this incentive scheme is not misused. It is evident that HMRC are taking steps to combat abuse of the regime, particularly in respect of SME claims. In 2012, the PAYE cap in relation to the available tax credit for loss-making SME businesses was removed. Correspondingly, the value of the SME scheme has increased. HMRC have been keen to strike a balance between preventing abuse while not negatively impacting companies performing true R&D.

Following two rounds of consultation where HMRC was keen to take on board the views of potentially impacted SMEs, HMRC plan to reintroduce a revised version of the PAYE cap for SMEs. Broadly this means that from April 2021, the amount of payable tax credit a qualifying loss-making business can receive is capped at three times their total UK PAYE and NICs liability for that year. The cap is most likely to restrict claims made by SMEs that primarily outsource development work or have minimal UK presence.

Going forward HMRC are considering further changes to the scheme, to bring it up to date with the current digital age. A consultation is ongoing into the potential inclusion of cloud and data as eligible expenditure. It's clear that HMRC have tried over the years to amend the rules to incentivise R&D to take place while closing the doors to fraudulent claims. We can expect the number of claims to remain high in the upcoming year, but with the changing rules companies will need to be careful to navigate through those changes in order to comply with the rules and ensure they are claiming their full entitlement.



The R&D tax incentives regime – trends and important changes (cont'd)

Our response to the R&D Consultation on expanding eligible cost categories

The recent HMT Consultation into expanding the R&D tax credit regime to include additional costs has now closed to responses. The Consultation focused on expanding qualifying cost types to include data acquisition and cloud computing costs in an effort to recognise the changing costs companies are now incurring when undertaking R&D activities. The Government needs to make sure the UK R&D regime is fit for purpose, and meets its policy objective of encouraging investment in R&D, particularly now in these unsettled times. Government has an ambitious target for innovation with investment in R&D at 2.4% of GDP by 2027, and it is imperative that the government incentives, such as the R&D tax credit regimes remain globally competitive to encourage investment in the UK.

Whilst the consultation is focused on the expansion of qualifying expenditure to include data acquisition and cloud computing costs, there is a requirement to ensure that this does not increase the overall cost of the R&D regimes. Therefore, any increase in expenditure types will need to be funded through the removal of other eligible costs – with the Consultation questioning whether the costs associated with qualifying indirect activities (QIA) should be removed. In our response to the Consultation we noted that there is a clear need to consider and evaluate whether data acquisition and cloud computing costs would offer greater incentive to invest in R&D than the current inclusion of QIA or other routine related expenditure.

Broadly, our view is that whilst we welcome the expansion of qualifying costs to data acquisition and cloud computing, we acknowledge that the impact on investment in R&D will be heavily dependent on the claimant's industry, with some industries benefiting more than others. Therefore these cost types do not necessarily offer the broad appeal of QIA based costs. We also recognise that some claimants find the inclusion of QIA costs helpful in reducing the complexity of identifying the time spent by teams on R&D, however, others struggle to robustly identify QIA costs. There is also a question over the benefit of QIA and how aligned the inclusion of those costs are to the policy intention of encouraging investment in R&D activities.

Given this opportunity to make sure that the R&D regimes meet the government's policy intention, as part of our response, we suggested other changes that may better incentivise companies and have a greater impact on investment in R&D in the UK. For example, inclusion of patent costs or mechanisms for ensuring faster repayments for those who need it.

Ultimately what is clear from discussions with many of our clients, is that any changes to the R&D regimes require clear guidance to ensure that claimants fully understand the eligibility criteria and can therefore confidently take the R&D tax credit benefit into account in investment decisions.

We look forward to the results of this latest consultation, and sincerely hope that any changes positively encourage innovation and an increase in investment in R&D. In conclusion, given the potential impact of the changes on qualifying R&D expenditure and the number of tech enabled transformation being undertaken in the insurance sector (as well as tech transformation required as a result of IFRS 17), it will be important that companies take note of any changes and model how this may impact their R&D claims. If you have any questions or would just like to talk about the UK R&D regimes please get in touch.

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Government launches review of Solvency II

What's new?

The UK Government launched a Call for Evidence ("CfE") on 19 October 2020 which is the first stage in the review of Solvency II post Brexit. The CfE covers the areas outlined by the Chancellor in his speech in June 2020 about plans to review certain features of Solvency II taking into consideration the unique features of the UK insurance sector. The proposals in the CfE also aim to ensure that the UK maintains an internationally competitive insurance sector without compromising policyholder protection and the safety and soundness of firms.

In the CfE, the Government seeks views as to how the prudential regulatory regime can better enable insurance firms to contribute to the Government's objectives to provide long-term capital to support growth across the UK and the Government's climate change objectives.

Separately, the Government is conducting a long-term review of the Future Regulatory Framework (FRF) Review to determine how the overall framework for financial services regulation will need to adapt to the UK's position outside the EU. The FRF Review will examine the allocation of regulatory responsibilities between Parliament, HM Treasury and the financial services regulators. See our At-a-glance for further details regarding the FRF Review here.

What does this mean?

The areas the CfE is focusing on for review are:

1. Risk Margin (RM): The Government intends to work with the PRA to reform the RM and notes that UK life insurers have increasingly reinsured longevity risk (offshore) to reduce the capital strain on their balance sheets created by the RM requirements. The Government is seeking views on changes to the RM methodology including modifying the current 'cost of capital' approach to help reduce the RM's size, volatility and pro-cyclicality.

2. The Government is interested in the role that the MA could play to better support delivery of its climate, 'levelling up' and long-term investment objectives, including in appropriate infrastructure assets. The CfE also seeks views on the application processes for the use of the MA and options to make the process simpler and more efficient.

3. Calculation of SCR: The Government seeks views on whether the current approach can be made less prescriptive, less complex and to increase the ability of regulators to apply supervisory judgement. Also of interest is the role that the determination of the SCR could play to support delivery of the Government's climate change objectives, the delivery of its Green Finance Strategy and to address the risks posed by exposure to 'stranded assets'.

4. Group Solvency: Current requirements only allow for the use of one group internal model in the calculation of the group SCR. In the CfE the Government seeks views on which issues should be considered to allow for temporary calculation of the consolidated group SCR using multiple group internal models following an acquisition or merger.

5. Transitional Measure on Technical Provisions (TMTP): The current application of TMTP deductions requires firms to maintain 'legacy' models. In order to address this issue, the CfE seeks views on alternative specifications for the transitional measure in the context of the wider changes that may result from the rest of the review. Additionally, the Government plans to consider ways in which the specification and calculation of TMTP could be made more proportionate.

6. Reporting Requirements: Insurance regulatory reporting comprises several layers: Solvency II templates, National Specific Templates, reporting expectations in supervisory statements, and ad hoc requests. The Government therefore invites comments on what changes could be made to create a reporting framework that is proportionate and balances costs vs benefits.

Government launches review of Solvency II (cont'd)

7. LIBOR: The CfE seeks views on any issues arising for insurance firms from the forthcoming switch from LIBOR to Overnight Indexed Swap rates.

8. Thresholds for regulation by the PRA under Solvency II: Currently firms with annual GWP over EUR 5m, and gross TPs over EUR 25m, are captured under SII. The Government seeks views on the scope of the application of SII.

9. Mobilisation of new insurance firms: 'Mobilisation' allows the firm some latitude to become established and grow before the other requirements apply. The CfE seeks views on the mobilisation of new insurance firms, including whether the current regimes contain barriers for new market entrants.

10. Branch capital requirements: Government expects a significant increase in the number of insurance firms accessing the UK market through branches in the future. Therefore the Government wants to explore how the branch regime can be reformed in order to increase the attractiveness of the UK as a destination for foreign branches.

What do firms need to do?

At this stage insurers may wish to consider which of the areas of review set out in the CfE is most relevant for their business and decide if they want to respond. In their response, firms are encouraged to include high quality supporting evidence as well as evidence on the costs and benefits of any proposals.

Life insurers may wish to monitor the changes to the RM and MA as these are likely to impact their reinsurance, capital management and investment strategies going forward. Firms that have applied to enter the Temporary Permissions Regime as well as international firms looking to set up operations in the UK might wish to consider how changes to branch capital requirements could impact their post-Brexit organisational structure.

What about tax?

There are no direct references to tax in the Treasury document, including in respect of LACDT in the SCR calculations. However, any changes to the calculations of various points noted above are likely to have a knock on impact on the tax balances in either the balance sheet or SCR (LACDT). In addition, the call for evidence requests examples of other areas of particular challenge in these calculations which may give insurers a further opportunity to engage with the Treasury and/or PRA around any particularly challenging areas in the existing rules for tax balances. We are happy to discuss if there are any particular tax concerns from the industry around these changes.

Next steps for insurers

The response period for the CfE ends on 19 January 2021. Some proposed changes arising from this CfE will require further, more technical, consultations by the PRA while other proposed changes may require legislation. Therefore, it is unlikely that any of the proposed changes would come into effect before FY 2022. The Government will set out how the reforms will be taken forward in its response to the call for evidence.

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Intra-group financing and the OECD financial transactions paper

Intra-group financing: how to reduce risks and scope of challenges ahead of the year end

The impact of COVID-19 across the insurance sector has been significant - whether that is the impact of business interruption or trade credit claims; the consequences on longevity and mortality; or the volatility of asset valuations over the period. However, equally important for many insurers has been the impact on capital and liquidity. For that reason, there is an increasing focus for many insurers on debt financing and structuring as well as cash pooling and liquidity management.

On top of that, earlier this year, the OECD issued final guidance on transfer pricing for financial transactions (the "OECD FT paper"), addressing thin capitalisation, loan pricing, guarantee pricing, cash pools and captive insurance. Whilst this guidance is only eight months old, we are already seeing the rise in the level of scrutiny by tax authorities, in addition to existing challenges on tax rules such as unallowable purpose. This increases the importance of ensuring that policies for intra-group loans, financing policies and cash pool arrangements are reviewed and updated in light of this, and that the purpose of intragroup transactions is clearly and robustly documented.

With year end approaching, insurance groups should review their intra-group financing policies with a view to optimising their liquidity positions, as well as reducing risks and the potential for tax authority challenge. The remainder of this article provides an overview of: (i) the key topics of the OECD FT paper and tax authorities' approach that insurance groups ought to consider now, as well as (ii) considerations with respect to the COVID-19 impact.

The OECD FT paper and tax authorities' approach: key issues for insurance groups

The OECD FT paper provides guidance on a number of key areas which impact both existing and future arrangements. The focus on captive insurance has a clear read-across for insurance groups, as discussed in detail in previous KUWT editions (see link: key takeaways of the captive insurance guidance).

Over and above this, the most significant areas for insurance groups to be thinking about are:

(i) the importance of the Group's overall financial profile and the impact of that on pricing intra-group financing arrangements (including approach to credit rating, analysis of the effect of group membership and the analysis of the Group's external cost of borrowing);

(ii) the increasing focus on demonstrating the commercial rationale for the amount, structure and terms of intra-group debt transactions;

(iii) the operation of cash pool arrangements in light of the recent guidance (including how the cash pool leader is remunerated, the rates paid to or by pool members and the allocation of the synergy benefits from running the pool); and

(iv) the evaluation of financial guarantees (which encompasses, for example, letters of credit).

Whilst transfer pricing litigation on financial transactions is not new, there has been a significant uptick over the last few years in the number of cases that tax authorities have raised and are prepared to litigate (covering many aspects from cash pooling to debt pricing). This coincides with an increase in focus and scrutiny on *evidencing* intra-group arrangements, including intra-group financing arrangements, many of which in the UK (notably, outside of banking and insurance) have been subject to the State Aid review in respect of partially exempt finance companies.

In practice, this evidence-based approach to financial transactions requires increasing efforts in gathering key evidence substantiating the positions taken (e.g. on decision-making processes); in relation to the commercial rationale of the financing arrangements; and in respect of terms and other conditions or market evidence.

Intra-group financing and the OECD financial transactions paper (cont'd)

COVID-19 impact - why does it matter for intra-group financing arrangements?

The downturn in financial performance and liquidity issues, that have impacted many groups as a result of the Covid-19 crisis, has resulted in a number of issues for insurance groups (as discussed in our newsletter published on 7 April 2020) including:

- short term (re)financing: any new debt instruments being put in place now will need to be carefully priced to take account of the impact of Covid-19 on the interest rate environment (both in terms of base rates, which have been falling and margins, which have been rising, albeit at different rates);
- long term capital and liquidity requirements: since insurance groups are subject to the capital constraints imposed by regulators, many are having to re-think the sources and structure of their capital base, which may require new instruments (e.g. qualifying Tier 1 or 2 debt) and increasing market evidence on terms and conditions on comparable debt activities in the market (e.g. evidence of refinancing/raising reg-debt in the market);
- liquidity arrangements including cash pools: given the backdrop of volatility in interest and foreign exchange rates and marked differences between sub-sectors across the insurance space this can put strain on existing group policies including dealing with the low or negative interest rate environment; and
- filing positions: Advance Thin Cap Agreements - many of which incorporate "debt covenants" - may need to be revisited to consider the impact of a downturn in financial performance as well as insurance groups that have taken a file and defend approach to their compliance obligations.

Finally, whilst not related to COVID-19, LIBOR is to be phased out by 2021 as a global benchmark for lending and borrowing creating a need to revisit those financial transactions based on this benchmark and take action accordingly, as we explored in our newsletter published on 17 April 2019.

Key takeaways

Taking the above together, it is timely for insurance groups to consider reviewing their intra-group financing arrangements. As the principles set out in the OECD FT paper begin to be implemented on a wide scale basis and the market impact of the COVID-19 pandemic becomes clear, ensuring that your intra-group financing remains appropriate is key.

The experience across the insurance sector is that many groups have a good head start here: they have actively considered upfront what appropriate intra group financing policies are and have implemented them effectively. The challenge now is whether frameworks remain fit for today's environment and whether those policies meet the emerging tax authority standards. The gap in many cases is a lack of clear documentary support - including evidence of why the arrangements continue to hold up or whether changes are required.

Those who are best placed have adopted a timely and proactive approach to applying the guidance and considering the broader financial environment in which their group operates. Therefore, as insurance groups embark on the finalisation of year end processes, it will be important to review and revisit as appropriate the intra-group financing policies, helping prepare for increased tax authority scrutiny on both new and historic arrangements in which contemporaneous commercial and tax documentation will form the critical evidence against which today's decisions will be judged.

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RITM3964653