Keeping Up with Tax for Insurance

March 2021

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Introduction

It has been an exciting month of tax updates and so we are delighted to share our March edition of Keeping Up with Tax for Insurance. With the highly anticipated Budget last week, there is much to talk about and we have provided a detailed summary of the implications of the Budget for tax and tax teams.

We are delighted to have launched our Global Insurance Run-off Survey 2021. This is the thirteenth edition of the Survey, which was produced in conjunction with IRLA and AIRROC. The growth in legacy activity predicted in the last edition of this survey has materialised, boosted by significant investment in both new and existing legacy players. The market has maintained its momentum, with over 100 legacy deals publicly announced since our last survey, consistent with the volume in the prior period.

The Government will publish a number of tax-related consultations and calls for evidence at the end of March. To allow for more transparency and scrutiny, documents and consultations that would traditionally be published at a Budget will be published on 23 March. Several consultations are an important part of the government's 10-year tax administration strategy to create a tax system fit for the challenges and opportunities of the 21st century. Read more in this HM Treasury press release.

The evolving treasury and international tax landscape makes it important to revisit the tax treatment of finance and treasury transactions. In particular, a group should review its CIR position in light of the impact of the covid-19 pandemic. In this article for Tax Journal, PwC's John Webb, Andrew Cotterill and Mairead Murphy review the key UK tax considerations for financing transactions and global treasury functions.

In this month's edition, we have included the following articles:

- **Budget 2021 - Insurance update**
- **Run-off & Tax**
- **The OECD Guidance as the bellwether for addressing PE and TP issues arising from the pandemic**
- **Research & Development tax relief claims - a new era?**
- **Court of Appeal Rules in Favour of Rothesay Life Plc in a Landmark Judgment**
- **Fokus Bank Claims Germany Update**

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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Budget 2021 – Insurance update

After a challenging 12 months, Chancellor Rishi Sunak has delivered the much anticipated 2021 Budget (documents are available here). A summary of the proposed measures and potential impacts for the Insurance sector are detailed in this article.

Headline messages

Company taxation

- As has been widely anticipated, the **UK corporation tax rate** will **increase** from 19% to 25% on 1 April 2023 for companies with profits over £250,000.
- The **trade loss carry back provisions** for corporate entities which suffer losses in 2020-21 and/or 2021-22 has been **extended from one year to three years**.
- A **130% "super deduction" capital allowances** rate has been announced for main pool additions with a **50% "First Year Allowance"** for special rate pool additions for two years.
- The **Diverted Profits Tax** rate will also **increase** from 25% to 31% from 1 April 2023.
- There are **no proposed changes to indirect taxes such as VAT and IPT**.
- The **R&D tax credit for SMEs** relief will be **capped** at £20,000 plus three times the company's total PAYE and NIC liability per annum.
- The Government has introduced further legislation in respect of the UK Hybrid Mismatch regime and UK loss relief rules and has repealed the EU Interest and Royalties Directive.

Employment taxes / Income taxes

- There will be an **extension** to the Coronavirus Job Retention Scheme or "**Furlough" scheme to 30 September 2021**.
- There are **no new proposed increases** for income tax, national insurance tax and capital gains tax rates.

ESG

- A number of announcements were made, including in relation a new **UK green infrastructure bank** and a new **retail green savings product** (see below for further details)

Other measures

- The **inheritance tax and pension lifetime allowance** thresholds will **remain unchanged.**
- The Government has announced various measures to boost high-skilled migration including a **simplified VISA process** for highly skilled workers.
- The Stamp Duty Land Tax **nil-rate band** will **remain at £500,000** until 30 June 2021, and then will **decrease to £250,000** until 30 September 2021.

In more detail:

Change in corporation tax rate

- From 2023, the rate of Corporation Tax will increase to 25%. There is not due to be any staggering of this increase.
- Businesses with profits of £50,000 or less will continue to be taxed at 19%. A tapered rate will also be introduced for profits above £50,000, so that only businesses with profits of £250,000 or greater will be taxed at the full 25% rate.
- To the extent that the proposed rise in corporation tax will result in a "significant" impact on deferred tax balances in draft financial statements, a potential disclosure may be required detailing the potential impact of this change in tax rate where material.

Extension to trading loss carry-back rules

- The trading loss carry-back rule will be temporarily extended from the existing one year to three years.
- Companies will be able to obtain relief for up to £2 million of losses in each of 2020-21 and 2021-22.
- The £2 million cap will also apply across a corporate group as a whole.
- Companies that are part of a group will be able to obtain relief for up to £200,000 of losses in 2020-21 and 2021-22 without any group limitations.
- This will be legislated in the forthcoming Finance Bill. Further detail on the group cap will be announced in due course.
- For Lloyd's Corporate Members, it is anticipated that the extension of carry-back rules for losses will apply to results declared in 2020-21 and 2021-22 unless Lloyd's specific provisions are introduced.
- This carry back extension will apply to trading losses, but it is not expected to be relevant to excess expenses carried forward under the I-E life tax regime.

Budget 2021 – Insurance update

Capital allowances

- From 1 April 2021 until 31 March 2023, companies investing in qualifying new plant and machinery assets will benefit from a 130% first-year capital allowance.
- Investing companies will also benefit from a 50% first-year allowance for qualifying special rate (including long life) assets.
- Companies with an accounting period end date which is not 31 March will be required to identify the date of expenditure to benefit from these "super deductions".
- The Budget documents do not indicate an upper limit to the new deductions.
- Where insurance companies are able to claim capital allowances on management and/or investment assets this is a welcome change.

Other measures

- **UK Hybrid mismatch regime -** Following a consultation announced at Budget 2020, and a second technical consultation on draft legislation published on 12 November 2020, the government is introducing changes to the Corporation Tax legislation containing the rules for Hybrids and other mismatches. The changes, which will be introduced in Finance Bill 2021 effect, *inter alia,* the definition of "dual inclusion income" (which may be of particular interest to US headed groups), and clarify non-application of the anti-hybrid rules to the CATA and companies within the securitisation regime.

- **Loss relief reform** - Following the change in loss relief rules from 1 April 2017, some groups may have been prevented from accessing an allowance to which they are entitled following an acquisition or demerger. This was deemed to be an unintended consequence of the legislation and the proposed changes seek to improve a number of areas including transfers of trade following a change of ownership and the computation of loss restrictions.

- **Repeal of the Interest and Royalties EU Directive** - Draft legislation has now been published (for introduction in Finance Bill 2021) which will repeal the UK legislation which implemented the EU directive into domestic law with effect from 1 June 2021. Payments of interest and royalties made by UK companies will therefore be subject to UK withholding tax unless treaty relief is available, mirroring the position for payments of interest and royalties (as well as of dividends) to the UK.

Employment taxes and personal taxation

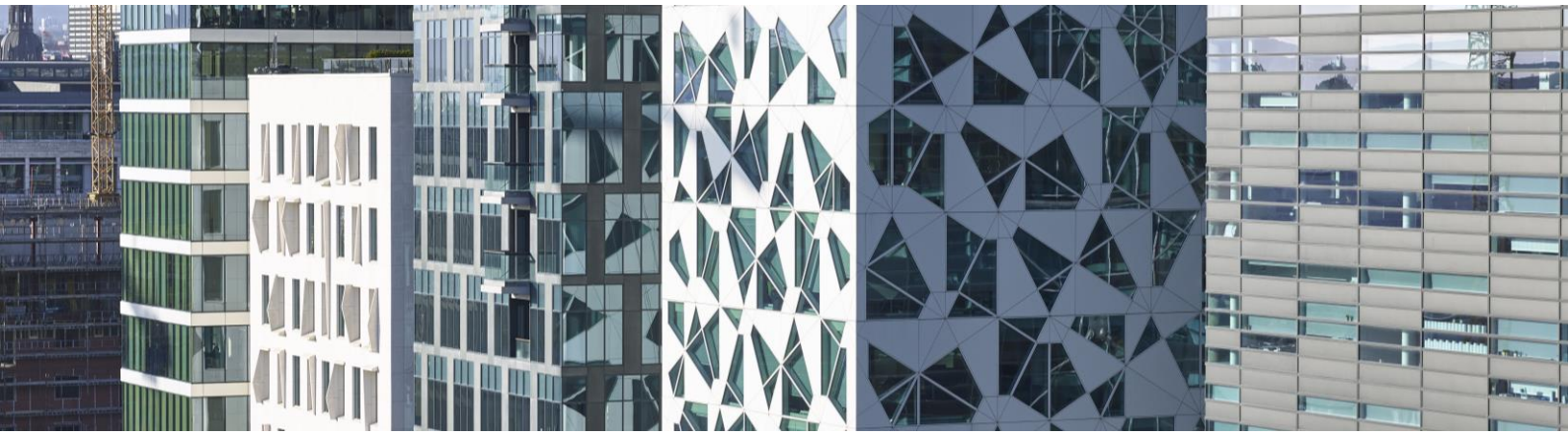
- **Coronavirus Job Retention Scheme**: The furlough scheme will be extended until the end of September 2021. There will be no change to the existing terms; employees will continue to receive 80% of their salary for hours not worked, up to £2,500 until July. From July, the government will introduce an employer contribution towards the cost of unworked hours of 10% in July, 20% in August and 20% in September.

- **Income tax:** The personal allowance will rise to £12,570 next year as originally planned, with the basic rate threshold and the higher rate threshold increasing to £37,600 and £50,270 respectively. The personal allowance and the two thresholds will then stay frozen until April 2026.

- **National Insurance Contributions**: As previously announced, the NIC primary threshold and Upper Earnings Limit will rise in 2021-22 to £9,568 and £50,270 respectively. Both will remain frozen until April 2026.

- **Capital Gains Tax Annual Exempt Amount**: The exempt amount, currently £12,300, is to be maintained until April 2026.

- Employers in England who hire a **new apprentice** between 1 April 2021 and 30 September 2021 will receive £3,000 per new hire. This is in addition to the existing £1,000 payment for all new 16-18 year-old apprentices and those aged under 25 with an Education, Health and Care Plan.



Budget 2021 – Insurance update

Environmental, Social, and Governance

- The government announced the establishment of a new **UK Infrastructure Bank**, to be headquartered in Leeds, and operating across the whole of the UK from later in Spring 2021. The bank will offer a range of financing tools including debt, hybrid products, equity and guarantees to support private infrastructure projects. The Bank will have £12 billion of equity and debt capital, as well as the ability to issue £10 billion of guarantees.
- The government will issue a sovereign **green bond** this summer, with total green gilt issuance for the financial year of a minimum of £15 billion. Further details on the planned expenditures will be set out in the green gilt framework to be published in June, but we note the UK government has indicated this will include spending towards social benefits such as job creation and levelling up, as well as environmental initiatives.
- A new **working group** will be established with the aim of positioning the UK and the City of London as the leading global market for high quality voluntary carbon offsets. The expertise of the UK's financial sector is expected to be drawn upon in order to ensure the success of this proposition.

Consultations

- **R&D**: There will be a consultation to explore further the nature of private-sector R&D investment in the UK, how that is supported or otherwise impacted by the R&D relief schemes, and where changes may be appropriate. It will look at:
  - Definitions, eligibility and scope of the reliefs, to ensure they are up-to date and competitive, and that they reflect how R&D activity is conducted now.
  - How well the reliefs are operating for businesses and HMRC, and whether this could be improved.
  - Targeting of the reliefs.
- A summary of the responses to the 2020 R&D consultation has also been published here.

- **EMI schemes:** The government is publishing a call for evidence on whether and how more UK companies should be able to access EMI schemes to assist with recruitment and retention of key talent.

- **Review of tax administration for large businesses:** Discussions will be initiated with businesses, advisers and other stakeholders over the coming months, to solicit views and build an understanding of the perceived challenges in this area, with a view to considering what improvements can be made as HMRC continues to progress its 10-year Tax Administration Strategy and wider Tax Administration Framework Review.

If you would like to discuss any of these areas in more detail, please get in touch with on of the contacts below or your usual PwC contact.

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Run-off & Tax

In common with most other areas of financial services, respondents to the Global Insurance Run-Off Survey had experienced a high level of deals activity over the past year and most expect the volume of transactions to continue at the same level we are currently seeing, or increase, over the next two years. We have been involved in several start-up run off businesses being established as well as existing operations acquiring new books of business via company acquisitions or Part VII transfer.

Tax is increasingly a key focus area when doing legacy deals - both in how tax can add value to a deal process and in how tax risks in a business can chip away deal value. Typically run-off businesses may have historic tax losses. We are seeing more potential buyers look to gain a level of certainty around whether they can unlock any of this value post-acquisition, especially due to some of the changes to the loss rules in recent years. Businesses can also gain value by considering structures, including VAT recharging, at an early stage. Wider commercial value can be gained by considering whether a finance and tax outsourcing solution would be appropriate, taking cost out of the model, creating more agility and flexibility in upscaling and allowing management to concentrate on commercial issues.

On the flip side, areas in which tax risk can arise include permanent establishment and residency, given the international footprint of businesses where the location of insured risk and where management takes place may not coincide. Whilst the pandemic has changed the business traveller landscape, at least temporarily, the “home worker” landscape has shifted dramatically and there is a desire from some to make international flexibility a feature of the talent war - this comes with tax consequences for individuals and the business.

Whilst these are largely commercial arrangements, tax legislation and practice in this area can be very complex.

Related to this, the UK’s Diverted Profits Tax and transfer pricing around reinsurance transactions are also areas in which we typically see a large proportion of the time spent on tax diligence focussed. Scrutiny should also be given during the due diligence phase to the historic and future VAT arrangements, especially on claims costs, where historic issues can give rise to large potential VAT liabilities.

There are also a number of recent tax developments which will affect businesses in the run-off space. The OECD’s BEPS 2.0 project addressing the tax challenges of the digital economy has important implications for the sector. Pillar II of the Blueprint documents, released in October 2020, addresses the basis for future agreement between member jurisdictions on development of global minimum tax rules. These apply to larger groups with annual revenues in excess of EUR750m. The objective is to ensure that global income, wherever sourced, is subject to a minimum tax rate. This has clear implications for the sector, where there are often entities resident in low or no tax jurisdictions, often chosen for their less onerous regulatory and capital regimes.

Whilst there is still a level of uncertainty around the requirements as they are still to be extensively debated, the OECD itself has suggested that a minimum tax rate may be around 12.5%. For groups where the effective tax rate in financial models relies on profits arising in the lower tax jurisdictions, and for modelling the returns on future acquisitions, the future impact of Pillar II needs to be carefully considered. Survey respondents typically expected to target an IRR of 10-20%, so it is crucial to understand the impact of tax on this. Businesses may already have made changes to operating models with knock on impacts on effective tax rates in preparation for Brexit. Even for unaffected organisations, there is likely to be a significant compliance burden as a result of these new regulations.

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The OECD Guidance as the bellwether for addressing PE and TP issues arising from the pandemic

The insurance industry has now been dealing for almost a year with major challenges arising from the pandemic. With business continuity and transformation at the forefront, some of the issues that tax departments are currently managing evolve around two areas: (i) virtual workforce and resultant tax (including permanent establishment or PE) issues; and (ii) transfer pricing ('TP') issues amid a changing economic environment. The OECD has lent its weight to efforts to provide guidance to help (taxpayers and tax authorities) address some of these unique tax challenges, resulting in welcome guidance on double taxation issues and TP.

The remainder of this article provides an overview of the key issues faced by the industry around remote working and TP models in light of the pandemic; how industry players have been approaching these to date; and what the latest papers from the OECD on double taxation and TP mean for the sector.

Cross-border working and PE

As discussed in our October edition, the issue of cross-border working raises a number of questions for the insurance industry, including legal, regulatory, corporate residence and employment tax. Focusing on PE implications, i.e. the risk of inadvertently creating a corporate presence in the country of remote working, we have seen insurers adopting one of three approaches to managing these risks to date:

- When lockdown and travel restrictions began to lift last summer, some insurers requested remote workers to return to their 'normal' working location and restricted (or altogether banned) future cross-border working.
- Others have established frameworks for monitoring and managing the risks, taking into account the regulatory implications and substance structures overseas (e.g. as a result of Brexit). For example, implementing formal approval processes and allowing individuals to spend a certain number of days working overseas, within limits.
- Still others have put in place measures to accommodate certain individuals working overseas on a more permanent basis, establishing branches or entities and allocating profit to reflect the activities undertaken.

Against this backdrop, the industry is re-assessing operating models to accommodate the longer term trend to a virtual workforce, particularly given the impact for recruitment, incentivisation and retention of key talent. Despite the useful guidance provided by the OECD on 3 April 2020, which focussed on the 'temporary and exceptional' nature of working arrangements arising as a result of various lockdowns and travel restrictions', insurers have been dealing with this in a context surrounded by uncertainty with respect to the local country position and little practical guidance (much of which is ambiguous and open to interpretation).[2]

On 21 January 2021, the OECD Secretariat published updated guidance on tax treaties and the impact of the COVID-19 pandemic ('OECD Secretariat paper'). The updated OECD Secretariat paper is intended to cover additional fact patterns that were not addressed in detail in April 2020. It provides helpful guidance for insurers to give more clarity (at least partially) when dealing with such uncertainty. The paper reflects a Secretariat view on the interpretation of various treaty provisions and is intended to provide a degree of certainty to taxpayers in interpreting treaty provisions in certain circumstances. However, it is noted that each jurisdiction may adopt different interpretations.

There is a clear recommendation to local tax authorities to acknowledge that people working from home during the pandemic, or temporarily having to conclude contracts outside of the employing entity's location, should not give rise to a PE, provided that public health measures are/were in place that restrict the ability of the employee to return to the employing entity's location.

This should help insurers to set (or improve) remote working frameworks. For instance, by stressing in what circumstances the displacement is caused by public health measures. However, the guidance recognises that if the individual(s) were located outside of the employing entity's location, or were habitually concluding contracts in that jurisdiction, before such measures commenced, or continue to do so afterwards, an analysis of all the facts or circumstances will be necessary to assess whether the activities have been performed with sufficient degree of permanence or habituality to create a PE.

2. Whilst a number of countries have issued specific guidance (e.g. Australia, Austria, Canada, Germany, Greece, Ireland, New Zealand, Singapore, the UK or the US), There is a notable variation in level of detail and assurance given between. For instance, the UK and Australia - where the Australian guidance lists specific criteria that will indicate that no PE should arise while the UK commentary is more generic and open to interpretation.

The OECD Guidance as the bellwether for addressing PE and TP issues arising from the pandemic

Impact of the COVID-19 pandemic on TP models

With market conditions hardening (particularly in the non-life sector), coupled with volatility in capital markets and asset valuations, the insurance industry is having to consider the financial impact on transfer pricing and in particular on intra-group reinsurance pricing. Alongside that, as insurance business models evolve (for example, leading to a more data focused and tech driven environment), collateral TP considerations arise. Some of these challenges were discussed in previous editions, such as in relation to intra-group reinsurance or intra-group financing.

The OECD issued guidance on TP implications of the COVID-19 pandemic ('the TP Guidance'), published on 18 December 2020. The TP Guidance represents the consensus view of the OECD and reinforces the applicability of the arm's length standard. It emphasises that the objective of any TP analysis is to 'find a reasonable estimate of an arm's length outcome' and recognises that taxpayers and tax administrations should exercise judgement in achieving that.

The Guidance stresses the role of risks in the context of the pandemic and the interplay between 'hazard risk' (used by the Guidance to define the pandemic) and other economically significant risks. Recognising the difficulty of defining which parties have the control over such 'hazard risk', the OECD Guidance stipulates the need to identify which group company exerts control over COVID-19 risks and how the group has responded to the manifestation of such risks. This approach is familiar to the insurance industry, given the long focus on risk assumption, mitigation and management (for instance, in adapting pricing or reserving to manage underwriting and reserve risk).

The Guidance further focuses on four areas: (i) losses and allocation of COVID-19 specific costs; (ii) comparability analysis, (iii) government assistance programmes; and (iv) advance pricing agreements. A summary of the key issues for the insurance industry is provided below:

- **Losses and allocation of COVID-19 specific costs**: Linked with the discussion of risks and risk allocation, the Guidance addresses losses and the allocation of COVID-19 specific costs, emphasising the importance of the allocation of risks between the parties to an intercompany arrangement, and how losses would be allocated between independent parties under a comparable arrangement. The read across for the insurance industry is whether and how the 'exceptional' losses (or profits in certain instances, e.g. for motor insurance) have materialised. Defining what is exceptional is central - what comes next is assessing whether those 'exceptional' losses/profits are borne by the appropriate party, by reference to legal and economic arrangements.

- **Comparability analysis.** Given the challenges of relying on historical data on current comparability issues (when those data do not reflect prevailing economic conditions), the TP Guidance discusses a number of practical approaches that can be adopted to address information deficiencies such as the use of macroeconomic data, adjustments based on taxpayer's insight or the use of statistical methods. For the insurance industry, the sharp end of comparability analysis is in testing arm's length prices for intra-group reinsurance . But other areas are relevant too: for example, pricing back office, claims handling or underwriting support. Benchmarking strategies used by the insurance industry will need to be adapted to the dynamic, and particular unusual, current market trends (e.g. performing regression analysis, using past information on insurance cycles, etc.)

- **Government assistance programmes.** The TP Guidance also discusses government assistance programmes (e.g. wage subsidies) and whether the economic benefit of such government assistance should be retained by the entity that directly receives it, or passed on to another related party. These are typically less relevant for re-insurers, though may have more relevance where furlough or other equivalent schemes have been utilised by insurance groups with large call centre or claims processing teams.

- **Advance pricing agreements**. The TP Guidance recommends a careful analysis to assess the extent to which, if any, the change in economic conditions affects the application of existing APAs or negotiation of existing APAs, encouraging a transparent dialogue between taxpayers and tax authorities. In practice, APAs in the insurance and reinsurance sector are relatively rare, so this area tends to be something of a niche sport for the industry.

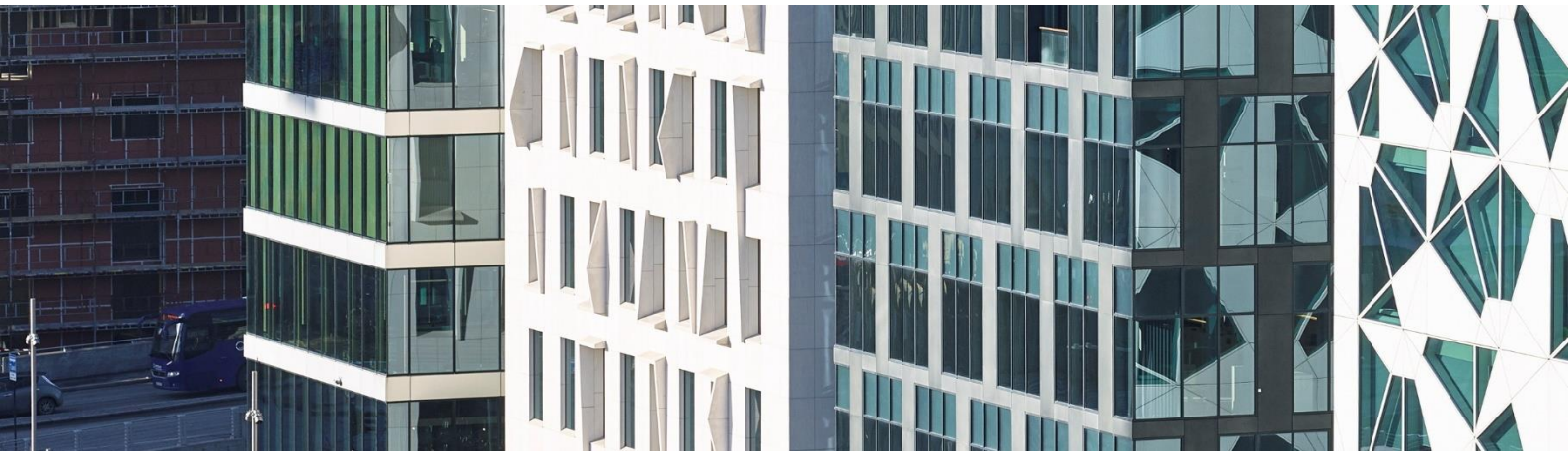
The OECD Guidance as the bellwether for addressing PE and TP issues arising from the pandemic

Key takeaways

Insurers should continue to monitor people's movements and identify how the guidance detailed in the OECD Secretariat paper will apply. In considering potential PE risks (both in the context of the pandemic and towards a more enabled virtual workforce), insurers will need to consider the nature of the displacement (including evaluating the existence of 'public health measures' and whether the OECD Secretarial paper and local guidance can be relied upon), the role of the displaced worker(s) (with particular sensitivity around underwriting); or and any existing presence of the wider group in the foreign location (either directly through a taxable presence or by 'fly-in' activities). Consideration should also be given to other potential risk areas, such as residence, employment taxes, regulatory, VAT and immigration.

Where the pandemic has had an exceptional financial impact on the business, any implications for TP models will need to be carefully assessed in light of the recent OECD TP Guidance. Any changes should be underpinned by a commercial rationale clear adherence to the arm's length principle. For example, any renegotiation of the terms and conditions to existing contracts, and the implementation of new agreements (e.g. intra-group reinsurance) should be in line with what independent parties would agree to under similar conditions, with a particular focus on whether the transaction would occur at all in present market conditions, the commercial rationale and the consequence for both counterparties to the transaction. Similarly, any change in the mark-ups of cost plus service providers should be supported by a robust comparability analysis.

In all cases, it will be important to gather appropriate evidence and documentation to substantiate the positions adopted (including limits imposed by travel restrictions and public health measures, together with contemporaneous records of internal correspondence on pricing and contract terms). These measures will ensure that insurance groups are well prepared for the coming tax authority scrutiny, which is expected to rise as governments increasingly focus on rebalancing fiscal budgets.



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Research & Development tax relief claims - a new era?

The Government has long recognised that a *'competitive R&D tax credit scheme'* is an important driver of its objective for the UK to become a global leader in science and innovation.

The most recent figures (for 2018/19) show over **£5.3bn** of R&D tax relief support was claimed just for that year, across 50,000 claims. 1,100 of these claims were in the Finance and Insurance industry, generating £275m in R&D benefit. In total, **over £28bn** in tax relief has been claimed across all of the R&D schemes. HMRC estimates that every £1 in R&D tax credits stimulates an additional £0.75 to £1.28 of R&D expenditure by Small & Medium sized Enterprises (SMEs), and between £2.40 and £2.70 of additional R&D spend by large companies.

It is clearly an effective stimulus. But there are growing concerns within the Government that R&D tax reliefs are open to error and potential abuse. The National Audit Office estimates **the level of error and fraud is over £300m a year**, leading the NAO to qualify HMRC's most recent audit.[1]

HMRC has taken three main steps to address these concerns:

- **Recruited an additional 100 extra staff** to review R&D claims. PwC understands they are now in post and actively reviewing R&D claims.
- **Accelerated plans to implement a 'random enquiry programme'** for R&D reliefs, in part to better understand the levels of error and/or deliberate overclaims.
- **Re-introduced a maximum cap on SME scheme cash claims**, from 1 April 2021. This will cap the cash credits for an SME to £20,000 plus 300% of the company's total PAYE and NICs liability for certain businesses. This could significantly impact SMEs that share R&D resources across their corporate group and/or outsource to third parties, and it is likely to impact biotech firms in particular.

So what does this mean for you?

We are approaching a new era for R&D tax claims: one of increased scrutiny of claims by HMRC through more enquiries, more challenges to R&D claims on technical and factual grounds, and a renewed emphasis on the overall quality of the evidence to substantiate the claim. This will likely impact a broad spectrum of claims, including those made on a similar basis to earlier years. It is more important than ever to ensure that you are making R&D claims with the input of specialists with a clear understanding of the R&D legislation and how it applies to software development in the Financial Services and Insurance sectors. Identifying qualifying R&D activities can be challenging, and there are a lot of misconceptions about what qualifies - navigating this is crucial to preparing a robust R&D claim.

One critical area to focus on is **the supporting evidence** for the claim. The burden of proof is on the claimant to establish their entitlement to the tax relief, and to substantiate the specific amount claimed. Claims should have clear eligibility assessments and project documentation, demonstrating the technological advance in question through measurement against the technical baseline. The documentation should focus on the underlying technical development, rather than on its functional requirements. Typically in Financial Services and Insurance, R&D is found within software development where the aim is an advance in non-functional requirements, such as performance, scalability and agnosticism. And remember: R&D claims are statements of fact by the claimant that they are entitled to the relief in the amount claimed.

There should also be a **clear strategy** underpinning the claim's preparation and submission. Think carefully about how you identify and collect relevant data, as well as how you present the claim to HMRC and how you interact with them - right from the beginning of any enquiry or correspondence.

1 A pdf version of HMRC's Annual Report and Accounts can be found here.

Research & Development tax relief claims - a new era?

Know the risks

HMRC can impose potentially substantial financial penalties on claimants that cannot reasonably evidence their claim, including where supporting evidence is incomplete or incorrect. Whenever a claim is amended as a result of an HMRC challenge, HMRC will always consider charging penalties. Whether a penalty is due and its amount will be driven by whether there is a 'reasonable excuse' for the adjustment, whether it is unprompted or prompted by HMRC, and any mitigation the claimant can establish.

In extreme cases, significant penalties can also apply under the Corporate Criminal Offence (CCO) regulations where corporates do not have reasonable procedures in place to protect against any deliberate overclaim. Large business claimants may face additional scrutiny and possible censure through the Senior Accounting Officer (SAO) regime where robust governance is required to support the claim.

There may be other implications of an enquiry into a claim. For example, HMRC might look into adjacent tax issues, such as IR35 for external workers. They might also focus on transfer pricing - not only where there is intra-group R&D activity, but also look at the wider question of identifying the value added by the R&D activity in the first place, including possible expectations of current and future revenues. We can expect to see more HMRC enquiries on this in the future.

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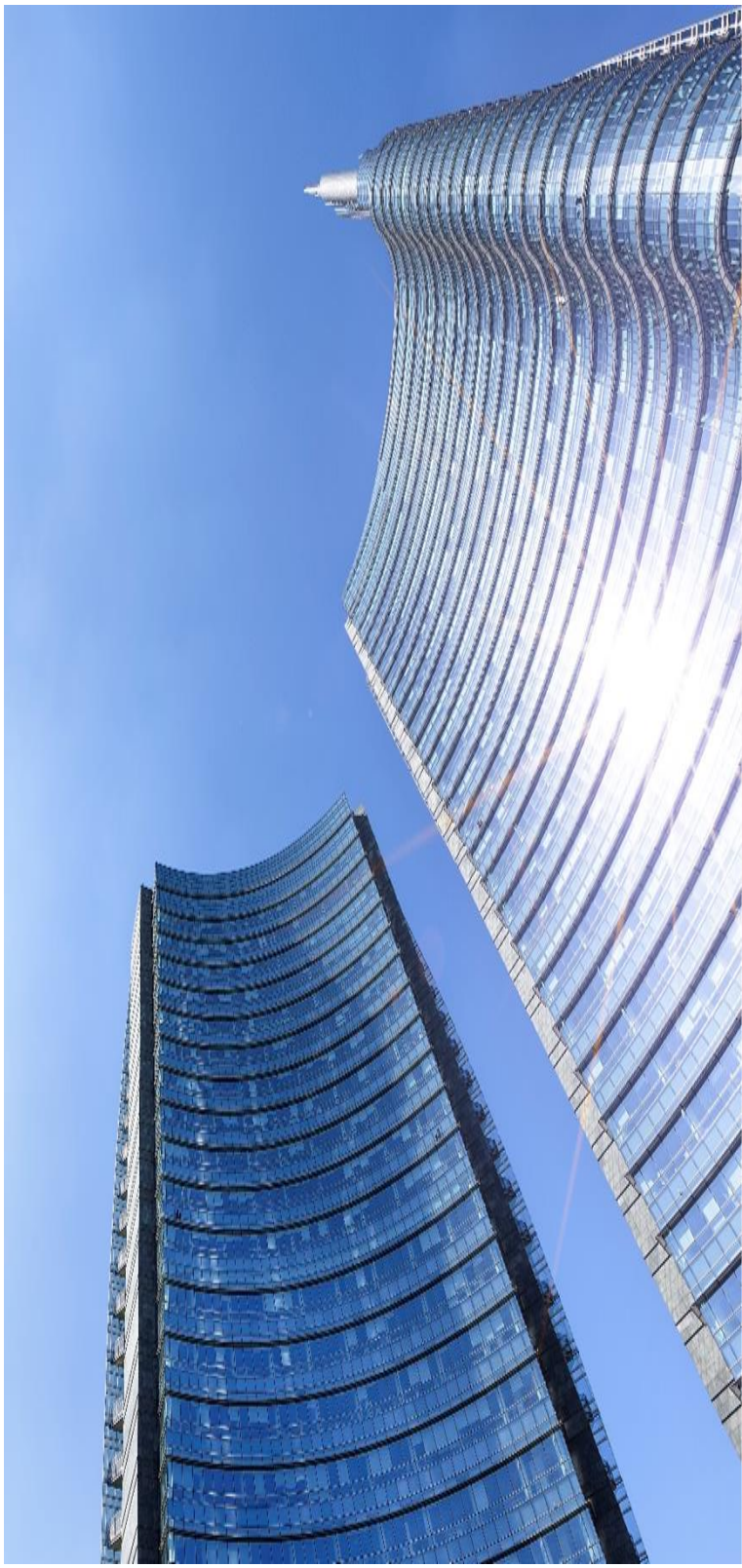

Court of Appeal Rules in Favour of Rothesay Life Plc in a Landmark Judgment

On 2 December 2020, the Court of Appeal overturned the High Court's decision to refuse to sanction the proposed insurance business transfer scheme between the Prudential Assurance Company Ltd ('**PAC**') and Rothesay Life plc ('**RL**'), and set out the correct approach to adopt by a court when dealing with similar applications. This was the first time for a Court of Appeal to consider an application under Part VII of the Financial Services and Markets Act 2000 ('**FSMA**') in such detail.

The Court of Appeal ordered that the proposed scheme be remitted to the High Court for a new sanction hearing.

Background

Part VII of FSMA establishes a court-sanctioned regime for transferring insurance policies between insurers.

In light of a planned demerger of Prudential plc's UK and European business from its business in Asia, the US and Africa; PAC sought to transfer around 370,000 annuity policies to RL, in order to reduce its regulatory capital requirements. Despite no objections from both the FCA and the PRA, as well as an independent expert concluding that the scheme would not have a material adverse effect on policyholders, Justice Snowden refused to approve the transfer. PAC and RL appealed against his decision.

The Court of Appeal upheld the central issues raised by the appellants and determined that Justice Snowden 'made errors in his approach to the exercise of his discretion'. The ruling states that Justice Snowden accorded too much weight to policyholders objections and not enough weight to the expert's conclusion and the Regulators' lack of objection.

The Court of Appeal stated that Justice Snowden 'misunderstood the nature of the continuing regulation of authorised insurers and its significance. [...] He disregarded the opinion of the expert and the PRA as to the appellants' future financial resilience on the false basis that those opinions were themselves founded upon only a snapshot of the current year.'

Justice Snowden was 'not justified in adding his own speculative conclusion that he could not be confident that the companies' balance sheets would not deteriorate materially over the life of the annuities' and 'was wrong to consider whether there was a material disparity between the external non-contractual support potentially available as at the date of the sanction hearing for each of PAC and RL. It was not a relevant factor once the Solvency II metrics were satisfied.' 'Insurers can be sold [...] and can reduce their surplus own funds at any stage. That is why the evaluation of an insurer's Solvency II metrics, taken together with the prospect of its continuing regulation, is both necessary and normally sufficient to measure its resilience to future events.'

'The appellants submitted that the judge wrongly attached weight to the fact that consumers had chosen Prudential for its age and reputation. [...] the court could not take that into account in the Part VII context. The court had access to the insurers' detailed financial information and Solvency II metrics, and the opinions of experts and Regulators, which all provided a far more reliable guide to the security of policyholders' benefits than any subjective factors which a policyholder may have considered prior to inception.'

Court of Appeal determinations

The Court of Appeal recognised that there can be no single test nor a single list of factors that can be applied in all transfer of insurance business cases. Given the wide range of businesses that may be transferred under Part VII and the even wider range of circumstances in which such transfers may be proposed, a court will be required to consider different factors, depending on the business and the circumstances.

The Court of Appeal also set out in detail the correct approach a court should take when considering a Part VII application. A court should:

- identify the nature of the business being transferred and the underlying circumstances giving rise to the scheme; and
- assess whether the transfer would have any material adverse effect on policyholders.

Court of Appeal Rules in Favour of Rothesay Life Plc in a Landmark Judgment

In its determination a court should only take into account and give proper weight to matters that ought to be considered and ignore others. The Court of Appeal identified that in the past authorities such as *Re London Life Association Ltd* were treated as having a comprehensive statement of factors that should be taken into account in all insurance business transfers. However, the factors identified in those cases were addressed to the particular circumstances and types of business being transferred.

The Court of Appeal also stressed the importance of the views of independent experts and Regulators in Part VII considerations. Unless a court identifies any errors, omissions or instances of inadequate reasoning in their opinions, when exercising its discretion, it should accord full weight to those. This, however, does not mean that a court can never depart from the recommendations of experts or the non-objections of the Regulators, but it does mean that in case of any departure a court must have significant and appropriate reasons for doing so.

Comment

This decision will have a significant impact on the UK insurance industry. Undoubtedly, the ruling comes as a relief to the market's participants who after the first instance's decision worried that a similar approach will be taken in other cases involving a large or long-established insurer and a smaller or more recently established entity.

The Association of British Insurers intervened in the case to express concerns of the industry, arguing that the principles applicable to Part VII schemes had to be clear and predictable, given the heavy time and cost commitment required to prepare them.

The Court of Appeal has restored the more conventional approach to the court's exercise of its discretion. By setting out detailed guidance as to the considerations a court should take in the future when dealing with a Part VII application, it provided more transparency and certainty to the process.

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Fokus Bank Claims Germany Update

Background to Fokus Bank Claims in Germany

The 2004 Fokus Bank Case (case E-1/04, Fokus Bank ASA) was a landmark case in which the European Court of Justice (CJEU) and the European Free Trade Association (EFTA) declared that withholding taxes (WHT) can have a discriminatory effect. They declared that WHT may violate the principle of free movement of capital and therefore is not in accordance with EU law if the tax becomes final for non-resident taxpayers while resident taxpayers are tax exempt or receive a refund.

Many EU and third country resident entities have challenged, and are continuing to challenge, the WHT that has been applied to portfolio dividend payments through 'Fokus Bank Claims' to recover the withholding tax suffered on this dividend income.

Following an infringement procedure of the European Commission the CJEU decided (judgement as of 20 October 2011, case C-284/09) that Germany violated European Union law by imposing WHT on dividends from portfolio investments held by non-resident EU or EEA corporate investors. This view was confirmed by the German Federal Fiscal Court (decision as of 1 January 2012, case I R 25/10).

As a result the German Corporate Income Tax Act (CITA) amendment excluded portfolio dividends received after 28 February 2013 from the applicability of the dividend exemption. Non-resident pension funds, life/health insurance companies and investment funds, however, still face discrimination in Germany with respect to WHT on portfolio dividends broadly as a result of the interaction of the tax treatment of actuarial/technical reserves that result in WHT being final for non-residents while residents can obtain a refund for the WHT.

Non-resident pension funds, life/health insurance companies and investment funds have traditionally faced difficulty reclaiming withholding tax on portfolio dividends in Germany. While a number of other EU territories have processed repayments to funds and insurance companies in respect of Fokus Bank claims, the German tax authorities had taken the approach that there are complex issues to consider and claims would only be processed once the Courts had considered these issues and required the German tax authority to take action.

This article provides an update on recent German cases, provides an outlook on what entities in these industries can expect in respect of Fokus bank claims in Germany and next steps to consider to protect their position.

Pending Federal Fiscal Court proceedings (I R 1/20 and I R 2/20) - Lux and French investment funds

Currently there are two ongoing proceedings, which involve investment funds from Luxembourg and France (SICAV and FCP). A WHT refund was applied in this case by the German authorities of 11.375% based on relevant tax treaties. A full refund was denied. The first-tier court (Fiscal Court of Hesse, 21 August 2019, 4 K 2079/16 and 4 K 999/17) ruled in favour of the German tax authority on the basis that the restriction of the EU freedom is justified by the coherence argument, i.e. the non-taxation of domestic funds is intrinsically linked with the taxation of its investors and the taxation of foreign funds is intrinsically linked with non-taxation of its investors. The two funds appealed the decisions and the case is now pending with the Federal Fiscal Court.

Federal Fiscal Court referral re Lux FCP (I R 33/17, ECJ C-537/20)

In this case the key question before the Court was whether a Luxembourg special investment fund can be subject to German corporate income tax (CIT) assessment whilst in a comparable domestic special investment fund would be exempt from CIT. In this instance the Federal Fiscal Court referred the case to the CJEU (case no. C-537/20) which raises questions in all three steps of the usual infringement test:

- Are foreign and domestic special investment funds comparable?
- If yes: Can a potential restriction be justified?
- If yes: is the measure (i.e taxation of foreign special investment fund) appropriate?

Pending case College Pension Plan of British Columbia (Fiscal Court of Munich, case no. 7 K 1435/15) PLUS ECJ decision of 13 November 2019 (case no C-641/17)

Like the Luxembourg and French investment funds discussed above, the Canadian pension fund in this case received a refund of 11.375% on the 26.375% German withholding tax they suffered based on the relevant tax treaty. A full refund was denied.

CIT of 15% is applied to German pension funds but they can deduct technical reserves in respect of its pension guarantee commitments. The Canadian pension fund (CPP) is not subject to CIT in Canada, however it does accrue technical reserves in a similar way to German pension funds.

The CJEU held that the final WHT for non-resident pension funds constitutes a restriction of the free movement of capital. The CJEU pointed out that a discrimination can only be assumed in cases that the non-resident pension fund is comparable to qualifying German pensions funds which are subject to specific insurance law requirements.

Fokus Bank Claims Germany Update

The CJEU held that non-resident pension funds are considered to be comparable to qualifying German pension funds, if they either voluntarily, or within the laws of their respective State of residence, accrue liabilities for future pension payment obligations.

The CJEU left it to the national court to examine whether this requirement is met by CPP. This case is pending with the Fiscal Court of Munich which will decide on the comparability of the technical reserves.

Furthermore, the CJEU held that the restriction is not justified by the balanced allocation of taxing powers, by the coherence of tax systems or by the effectiveness of tax supervision because Germany does not tax the dividends at fund level in a purely domestic situation.

Finally, the CJEU held that the legislation in dispute is not covered by the so-called stand-still clause (Art. 64 TFEU) as the measure does not relate to capital movements to or from third countries involving direct investment or financial services.

German Fiscal Court of Cologne re obligation to pay interest (case no. 2 K 140/18)

A Netherland corporation was the beneficial owner of shares in a German corporation and received dividend payment in 2016 and as a result applied for an exemption from German withholding tax. The German Fiscal Court ruled that the taxes were withheld in breach of EU law and as a result interest was payable on CJEU case law. In this absence of EU legislation on interest, each member state sets out the conditions for how the interest rate is calculated and the situations that it would be paid. German tax law rules are to be applied in this instance (i.e 0.5% per month, 6% per annum). Interest on taxes withheld that are not in accordance with EU law must be granted on the duration of its unavailability (from date of undue payment of the tax and date of repayment).

Key takeaways and actions for insurers

Optimism over German Fokus Bank Claims appears to be growing. There is now deemed a greater chance of success by our German colleagues for EU claims for the likes of pension and investment funds as well as life insurers.

The promising German Fiscal Court of Cologne ruling was the first decision by german court to apply EU law in respect of interest payable. Given the period of time that many entities' Fokus claims have been ongoing, interest could be relatively significant and for earlier years, comparable to the quantum of tax at stake.

Entities should consider filing interest claims for EU refunds in Germany given that the relatively high interest rate of 0.5% per month (6% per annum) could lead to a significant amount of money reclaimed.

By law interest should apply already so it is arguable that entities do not need to submit a filing. However, we would recommend that entities consider filing claims for the full amount WHT including interest.

There is also a possibility that the German legislator might attempt to change German procedural provisions in order to make it harder for foreign taxpayers to claim interest for Fokus bank filings in the past.

It is recommended that entities:

- Actively safeguard interest claims for EU refunds;
- Initiate a high level comparability analysis for individual claimants. Gaining an understanding of what extent you are comparable to similar cases can help to ascertain the chances of the claims success; and
- Challenge the German tax authorities to speed up the refund process. We do not see a lot of engagement from the German tax authorities so being proactive would ultimately help expedite the claims process.

Following this, preparation of full claims (i.e. regularisation) will be required. Note that court proceedings should typically be expected in order to resolve claims.

While there have been a number of recent positive developments, our German tax colleagues do still expect claims to take 2-3 years to be resolved, and consider there to be a high chance the claims will go through the courts. In claims where there is no comparison with existing cases, the case may ultimately need to go to the CJEU.

If the comparable analysis is positive then we see good reasons at this stage to pursue claims.

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