CEA

Tax Treatment of Financial Institutions
- Insurance Industry -

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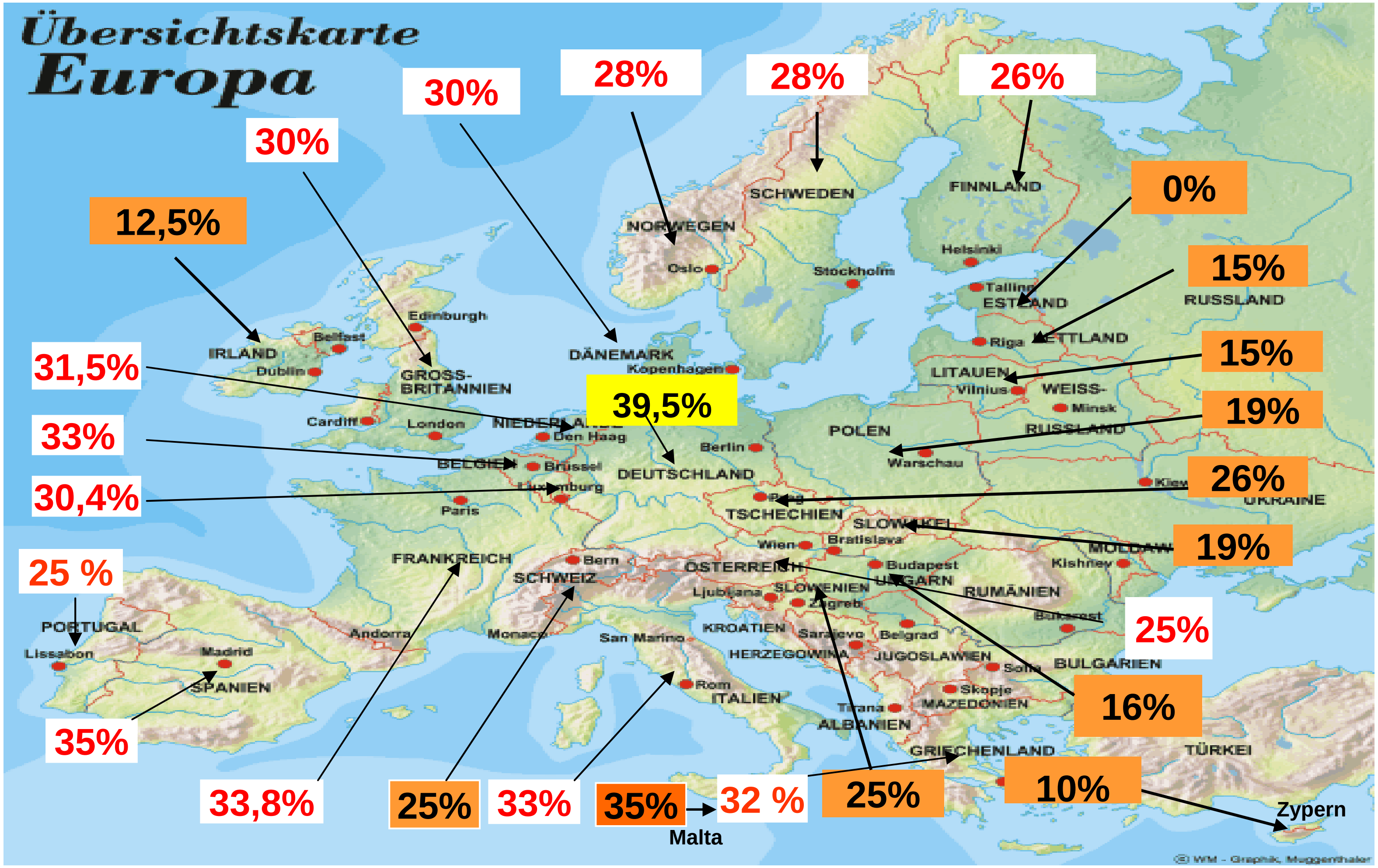
Agenda

1. Overview of the Tax Environment in Europe
2. General Requirements for Introducing a Common Consolidated Corporate Tax Base
3. Basic Requirements for Financial Institutions, especially the Insurance Sector

1 Overview of the Tax Environment in Europe

1. **Tax Rates as Indicator for Tax Burden**
2. **Influence of IAS/ IFRS on Tax Balance Sheet Law**

Overview of the Tax Environment in Europe
1. Tax Rates as Indicator for Tax Burden



Overview of the Tax Environment in Europe
1. Tax Rates as Indicator for Tax Burden

- Tax Rates as indicator for the effective tax burden – taking the tax base into account
- However: Tax payers' problems to find the best location for doing business
- Target should be fair tax competition via tax rates, not via tax base

  ➔ Support from the insurance sector for a Common Consolidated Corporate Tax Base
- Impact:
  - Common Tax Base
  - Consolidation
- Basic Community Law has to be taken into account
  - Non discrimination of EC residents
  - Free movement of capital
  - Freedom of establishment

Overview of Tax Environment in Europe
2. Influence of IAS/ IFRS on Tax Balance Sheet Law

- Some of the Member States define their tax base based on national GAAP ("Principle that tax base follows accounting principles")
- Influence of IAS/ IFRS on national GAAP: Modernisation of GAAP; modernisation of EC Directives
- Can IAS/ IFRS be taken as a tax base ?
  - IAS/IFRS are from a <u>formal point of view</u> not suitable for calculating taxable profits: No democratic authorization of IASB; legislative sovereignty
  - IAS/ IFRS are from a <u>material point of view</u> not suitable: taxation of unrealised gains; management judgements, discretion; taxation of profit projections
- Definition of an EC - tax balance sheet law
  - independent from IAS/IFRS and other accounting principles
  - but taking IAS/IFRS, if and as long as in line with basic taxation principles

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General Requirements for Introducing a CCCTB

1. One Set of Tax Rules – taking the Specialities of Certain Sectors into Account

2. Future Tax Base Definition in Line with Important Taxation Principles

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General Requirements for Introducing a CCCTB

1. One Set of Tax Rules – taking the Specialities of Certain Sectors into Account

- General tax rules should in principle not differentiate between business sectors
- However: Specialities of certain sectors ask for specific rules, but only
  - to the extent a separate set of rules is necessary from an economic point of view (in order to reflect business needs) or as a consequence of supervisory law
  - in compliance with general basic taxation principles (no hidden subsidies)
  - E.g.: insurance provisions, treatment of trading books and loan portfolios of credit institutions
- Discussion in a separate subgroup with sectorial experts desirable
- Differentiation between financial institutions, e.g. different solutions for insurance and banking in some areas reasonable

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General Requirements for Introducing a CCCTB
2. Future Tax Base Definition in Line with Important Taxation Principles

- Taxation according to the individual ability to pay taxes
  - Realisation principle (taxation only of realised gains; cost principle)
  - Taxation on net income (not on substance)
  - Matching principle
  - Please note: interdependence between provisions, valuation of assets at a lower fair value and loss utilisation (unrestricted loss carry back)
- Neutrality between legal forms (corporations and limited partnerships) and irrespective of organisation (organisation via branches vs. subsidiaries)
- Reduction of administrative burdens
- Clear, unambiguous wording, independent from IAS/ IFRS and local GAAP
- Certainty about legal position, certainty in tax planning

3 Basic Requirements for Financial Institutions, especially the Insurance Sector

1. Recognition, Measurement and Evaluation of Financial Assets
   1. Valuation at Cost or Fair Value for Financial Assets
   2. Valuation Allowances
2. Deductibility of Technical Provisions
   1. Technical Provisions – General Rules
   2. Specific Important Technical Provisions (Examples)
3. Consolidation vs. Group Taxation
4. Other Topics
   1. Use of Losses
   2. Restructurings of Companies/ Groups
   3. CFC Legislation

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Basic Requirements for Financial Institutions, especially the Insurance Sector
1. Recognition, Measurement and Evaluation of Financial Assets

1. **Valuation at Cost or Fair Value of Financial Assets**

- Financial assets are “core business”
- IAS 39 not appropriate: normally long-term investments, investments in order to comply with future claims payments (contrary to trading books of credit institutions)
- General principles for insurance companies
  - Valuation at cost; no taxation of unrealised gains

2. **Valuation Allowances**

- Application of general rules as for any other company; Necessity of valuation at a lower fair value dependent on loss carry forward and loss carry back possibilities
- Valuation units in order to avoid distortions (e.g. hedging)
- Specific rules in personal lines of business (e.g. life insurance)

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Basic Requirements for Financial Institutions, especially the Insurance Sector
2. Deductibility of Technical Provisions

1. **Technical Provisions - General Rules**

- Negative list of non-deductible items preferable (reasoning: business developments and potential need for new, so far unknown provisions)
- Most insurance provisions are in line with general rules and mandatory; important due to the kind of business:
  - Provisions not only if legally but as well if (only) economically incurred
  - Provisions for claims incurred but not yet reported
  - Provisions acc. to matching principle

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Basic Requirements for Financial Institutions, especially the Insurance Sector
2. Deductibility of Technical Provisions

2. Specific Important Technical Provisions (Examples)

(1) Provisions for Claims Outstanding

- Legal and/ or economic third party obligations
- Provisions independent of knowledge on a single case basis (IBNR's)
- Calculation on a single case basis vs. mathematical/ actuarial calculation; important: best estimate approach
- Discounting of claims provisions ?
  - Discounting means taxation of unrealised gains
  - To what extent and under which conditions acceptable (taking inflation into account, approach of the Insurance Directive (long-term provisions)) ?

3 Basic Requirements for Financial Institutions, especially the Insurance Sector
2. Deductibility of Technical Provisions

2. Specific Important Technical Provisions (Examples)

(2) Equalisation Provisions

- Target is to equalize fluctuations in loss ratios over the time (premium levied might be on average sufficient, but experience shows that claims payments in one year can by far exceed the premiums earned, e.g. hail and storm)
- In “good years” a certain amount has to be set aside in order to be able to cover those losses
- Equalisation provisions reflect the ability to pay taxes principle
- If equalisation provisions were not tax deductible, an unrestricted loss carry back would be required (otherwise potentially taxation of profits which will never be earned) ➔ Provision must be seen in the context of loss treatment, esp. loss carry back possibilities
- Calculation based on statistics

2. Deductibility of Technical Provisions

2. Specific Important Technical Provisions (Examples)

(3) Catastrophe Provisions

- Necessary in order to comply with business needs
- Some risks would not be insurable if provisioning were not allowed (e.g. earthquake, nuclear risks, some pharmaceutical risks, terrorism
  - no sufficient experience in the past (no possibility to calculate premiums properly) or
  - no cyclical business
- Similar treatment as equalisation provisions (dependent on loss carry back possibilities)
- Prudent calculation (amount set aside will very often be not sufficient in any case)

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Basic Requirements for Financial Institutions, especially the Insurance Sector
2. Deductibility of Technical Provisions

2. Specific Important Technical Provisions (Examples)

(4) Provisions for Bonuses and Rebates

- Third party obligations
- Direct claim by one policyholder or claims of the insurance collective
- Two possibilities:
  - Amounts already attributed to a single policy holder or to a specific collective of insured (deductibility)
  - Amounts which are attributed to policy holders, but which can - in a worst case scenario – (partially) be taken in order to level the insurance company’s operating losses (definition of maximum amount necessary)

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Basic Requirements for Financial Institutions, especially the Insurance Sector
2. Deductibility of Technical Provisions

2. Specific Important Technical Provisions (Examples)

(5) Unit linked Life Insurance

- Risks/ chances are borne by the insured
- This has to be reflected in calculating provisions and valuation of assets
- i.e.: parallel valuation of assets and liabilities (taxation of margin); idea of “valuation unit”

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Basic Requirements for Financial Institutions, especially the Insurance Sector
3. Consolidation versus Group Taxation

- Consolidation best reflects the Single European Market and leads to a fair taxation of European insurance groups in comparison to competitors (no tax disadvantage)
- Taxation acc. to the Group's ability to pay taxes (cross border profit & loss transfer, elimination of gains not yet realised in the market, no transfer pricing problems)
- Is Consolidation realistic ?
  - Problem to allocate the tax base to the prevailing Member States
  - Treatment of activities in third countries (only partial consolidation)
- If consolidation cannot be achieved short term:
  - EC- group taxation (subsidiaries/ branches) as an alternative (cross border loss transfer, reintegration of gains up to this amount afterwards)
  - Please note: Taxation of capital gains/ dividends to be resolved (at least towards third countries; tax exemption preferable (avoidance of economic double taxation)

3 Basic Requirements for Financial Institutions, especially the Insurance Sector
3. Other Topics

1. Use of Losses

- Unrestricted loss carry forward and – dependent on the concept followed as far as unrealised losses and provisions are concerned – possibility for loss carry back
- Cross border utilisation of losses as long as consolidation can not be achieved
- No minimum taxation: Minimum taxation (e.g. taxation of profits up to a certain amount even if loss carry forward exists) lead especially for volatile sectors to taxation on income which will in the end never be earned

2. Restructurings of Companies/ Groups

- Restructuring within the EC (cross border) without any (immediate) tax consequences
- European Merger Directive seems not to fully comply with EC primary law
- Abolishment of real estate transfer tax in case of an internal restructurings

3 Basic Requirements for Financial Institutions, especially the Insurance Sector
3. Other Topics

3. Double Taxation Conventions/ CFC Legislation

- One Double Taxation Convention EC towards third countries desirable
- Anti abuse provisions – though potentially in line with EC law – have to comply with the freedom of establishment, freedom of capital transfer

4 Résumé

- The concept of one Single Market, combined with EC Primary Law and taking the ECJ decisions into account inevitably leads to a Common Consolidated Corporate Tax Base.

- The current discussions are a unique chance to improve the Single European Market's tax environment towards competitors, e.g. the US and Japan (and this not as a long term project !).

- This is a chance not just for improving business conditions.

- Better conditions for doing business within the EC mean more taxable income in the EC. Be it via corporate taxes, income taxes, wage taxes or VAT.

- The Federation of European Insurers will support all efforts.