ADVISER

NAVIGATING CORPORATE INCOME TAX LIABILITY

Increasingly, multinational companies (MNCs) have faced scrutiny from local tax authorities for unpaid premium-related taxes, such as in Canada, US, Switzerland, and certain EU member states. While premium-related taxes (on average, 10% of total premiums) cannot be ignored, the most significant hidden cost facing MNCs is potential corporate income tax liability (on average 25%) on claim monies received. However, such a potential charge is frequently ignored during the renewal strategy and placement stages.

POTENTIAL CORPORATE INCOME TAX RISK FOR MNCS

Generally, the foreign subsidiary of the MNC is covered under a local policy as well as under a master, excess, or umbrella policy. At the time of placement of these policies, the MNC is unaware that, in the event that the foreign subsidiary suffers a loss in excess of the local policy limits, the master/excess programme insurer(s) typically will not pay the claim directly to that local entity, particularly where non-admitted insurance is not permitted. Instead, it will pay the loss to the ultimate parent company, such that on receipt of the claim amount, the ultimate parent company may incur corporate income tax at an average rate of 25% – therefore giving rise to an unbudgeted tax surprise for the insured group. Furthermore, there is a risk that the MNC could be challenged by the tax authorities under the local anti-avoidance and value shifting tax rules, which could lead to additional penalties for the MNC and its foreign subsidiary.

CASE STUDY

A MNC arranged a local insurance policy in respect of the general/products liability risks of a foreign subsidiary located in a country where non-admitted insurance is not permitted (such as Brazil, China, or India) for a local limit of EUR1 million. However, the MNC has significant operations in that country and the foreseeable expected/potential maximum loss is estimated to be EUR15 million. A master policy, arranged with an insurer resident in the country of the MNC, provided cover above the local policy limit of EUR1 million.

The MNC did not objectively evaluate the potential general/product liability exposures that may subsist in group entities located in countries where it has significant operations, and relied on an inadequate local policy complemented by the higher limits provided in the master and excess policies.

The foreign subsidiary suffered a total loss of EUR11 million and was required to compensate the third-party claimant for EUR11 million. The local insurer paid part of the total loss up to the local limit of EUR1 million, as per the local policy, to the local insured. The foreign insurer, however, paid the balance of the total loss to the ultimate parent company under the master policy of EUR10 million. Therefore, the foreign subsidiary had a potential shortfall in its cash flow and financial statements of EUR10 million.

While the MNC received compensation for the total loss suffered by the group, unfortunately the parent company suffered corporate income tax liability worth EUR2.5 million on the EUR10 million it received from the master insurer. The MNC transferred the funds to its foreign subsidiary by way of capital injection. This transfer of funds led to a challenge by the local tax authorities for additional taxes (mainly corporate income tax) to be paid – therefore potentially leading to double taxation. This example is illustrated in the table below:

		Profit and loss (P&L) account of foreign subsidiary in a NANP* country (EUR)	P&L account of parent (EUR)
	Premium expense paid to foreign resident insurer centrally for risks located in NANP* countries – premium taxes may not be paid correctly.		(1,000,000)
⚠	Corporate income tax relief foregone in home country of parent and in the foreign country – average corporate tax rate 25%‡ (as the premiums should not be recharged).		(250,000)
	Loss suffered by the foreign subsidiary – reflected in its P&L account.	(10,000,000)	
	Claim received from foreign resident insurers by the ultimate parent and reflected in its P&L account – therefore may be treated as "taxable" income.		10,000,000
⚠	Tax may be suffered by ultimate parent on claim received – average corporate tax rate 25%‡.		(2,500,000)
	Transfer of net cash by the ultimate parent to foreign subsidiary via new capital injection – may be reclassified and treated as "gift income" and suffer additional corporate income tax locally.	7,500,000	
⚠	Potential risk of double taxation: Tax liability by the foreign subsidiary on the amount received by the ultimate parent – say, at 25%‡.	(1,875,000)	

* NANP = non-admitted insurance is not permitted.

‡ Corporate tax rates vary depending on the jurisdiction and period.

RECOMMENDATIONS FOR MULTINATIONAL COMPANIES

Could this additional unbudgeted corporate income tax cost have been avoided by the MNC? Perhaps. If the local policy had been for limits equivalent to the expected/foreseeable maximum loss, then it is possible that most, if not all, of the adverse corporate income tax liability could have been mitigated. In order to avoid a similar situation, MNCs should:

- Objectively evaluate the foreseeable expected/potential maximum loss that each group entity (that has significant operations) could suffer – particularly, if the MNC is resident in a country that does not allow non-admitted insurance.
- Arrange local policy limits equal to this foreseeable expected/maximum potential loss.
- Additionally, where possible, ensure that the local policy wording mirrors the master policy wording, subject to any local laws/regulations and translation issues.
- Consider the use of a captive (re)insurance vehicle to support the global insurance programme and the appropriate local policy limits.
- Consider the use of a financial interest cover clause in the master and excess policies after understanding the full implications for the MNC.
- Consider negotiating a tax warranty and indemnity clause to be included in the master policy to mitigate any potential net adverse corporate income tax impact on the insured group.
- Consider implementing a premium allocation methodology for the master and excess policy premiums, based on exposure and the likelihood of a loss exceeding the local policy limits.

Taking these steps can help towards ensuring that the insurance programme is "fit for purpose", the potential loss is appropriately covered, and any potential adverse tax issues are mitigated. If you have any questions about insurance regulations and premium-related tax issues affecting your global insurance programmes, please contact:

PRAVEEN SHARMA
Global Leader of Marsh's Insurance
Regulatory & Tax Consulting Practice
+44 (0)20 7357 5333
praveen.sharma@marsh.com

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