Insurance Tax Highlights – Asia Pacific

Hong Kong Transfer Pricing Update

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Transfer Pricing has been in the news again this year with a variety of publications by the OECD and national tax authorities, and because of the increasing number of transfer pricing audits around the region. With that in mind, we have dedicated this article to discussing the transfer pricing issues arising from perhaps the most commonly occurring related party transactions for insurance groups operating in Asia - head office and central service transactions.

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Head office and centralised service transactions are common to almost all multinational insurance groups since almost all insurance groups centralise certain activities in their global or regional head office to benefit from enhanced control and economies of scale. In fact, for most groups, there are several layers of centralisation with certain functions pooled at head office and/or regional head office level, as well as within shared service centres in China, India or the Philippines.

The technical side of transfer pricing for service transactions focuses primarily on three issues:

- Service recipients should only be charged for activities that benefit them - that is, they should only pay for services that they would be willing to perform themselves, or that they would be willing to pay a third party to perform. Meanwhile, they should not pay for shareholder or stewardship functions, which are only required because they are part of a multinational group, and they should not pay for central activities that duplicate functions that they perform locally.
- The service provider should calculate the service fee that it charges the service recipient using one of the five widely recognised transfer pricing methods. Most commonly, the selected method calculates the service fee based on the costs incurred plus a mark-up which is typically between 5% and 10%. However, where the service provider is a head office and the service recipients are branches, often no mark-up is added and there is instead simply a recharge of costs.
- The cost/fee that the service provider charges should be split between the service recipients on a fair basis that approximates the way that the fees would have been split at arm's length. Often, there will be certain types of activity or cost that only benefit one service recipient and they will be fully charged for that activity. More commonly, the majority of services that are provided benefit multiple related parties and the taxpayer has to select an allocation key or series of allocation keys to fairly allocate the costs/fees between them.

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Service transactions are frequently challenged by tax authorities and regulators around the region. Why tax authority challenges are so frequent is partly the result of service transactions being very common, but it is also because the transfer pricing considerations for service transactions are much easier to understand than the transfer pricing considerations for reinsurance, retrocession or asset management transactions. Furthermore, tax authority challenges are likely to increase now that the OECD has branded central service fees a 'high risk transaction' in its comprehensive action plan on Base Erosion and Profit Shifting (BEPS). Most often, the challenges take one of the following forms:

- The tax authority in the service recipient location argues that it has not been presented with sufficient evidence of the local entity benefitting from the services that have been provided and therefore disallows all, or part, of the deduction.
- The regulators in the service recipient location challenges the outsourcing/off-shoring of certain functions and refuses to allow the service recipient to recognise the charges in its accounts (with the knock-on effect in most cases that they can't be deducted for local tax purposes).
- The tax authority in the service recipient location challenges the deductibility of the mark-up, particularly where it has been charged to a branch, or challenges the allocation key that has been used because it is not specific enough (for example where a group allocates all central costs in line with the turnover of the service recipients).
- The tax authority in the service provider location challenges the mark-up applied and argues that a much higher mark-up should have been adopted. To date, the author is only aware of this happening on a recurring basis in India but, with wide spread discussion of the concept of location savings, this issue could easily spread to China and beyond.
- The tax authority or regulator objects to a payment/deduction on the basis of a technicality - such as the fact that the service level agreement is out of date and doesn't accurately describe the service activity, there has been no independent verification of the fee calculation, the taxpayer can't provide evidence they actually settled the payments etc...

Preparing for and dealing with these challenges is not the only difficulty in implementing and maintaining a central services transfer pricing policy. In particular, often there will also be internal challenges around timely information availability and about the impact that central service charges have on local budgets and profitability around the region. Also, it can't be ignored that there are tax costs of implementing central service charges to locations which will charge significant service taxes, whilst at the same time, challenging the deductibility of the service charges. In many cases this means that a question will arise as to whether it is better to minimise tax inefficiency by leaving one or more countries outside of the central recharge policy, and/or to maximise consistency by applying the same policy and process to all of the companies in the group.

In other cases, there will be a conflicting question of how much local input to get into the recharging policy and process. On the one hand, since some tax authorities and regulators are concerned about charges that have not been reviewed and pre-agreed by the local taxpayer, there is clearly an argument for having significant local input. On the other hand, many central tax departments may be concerned that local staff may act from a desire to reduce central service fees to increase local profits rather than only from a desire to achieve the correct transfer pricing. Central tax teams may also be concerned about the administrative burden of engaging multiple local stakeholders simultaneously.

Recognising the challenges outlined above exist and are not going away, there are a number of actions that we suggest to be taken:

- **Have a strategy –** recognising that it is likely that the central service charges will be challenged, taxpayers should have a strategy for dealing with such challenges. They should also understand the tax impact and risk profile of their legacy policy, and consider whether it is the most appropriate of the alternatives that are available.
- **Get the basics right –** ensuring that legal agreements are in place and up to date, that invoices are prepared, that calculations can be reconciled and have been certified where required, that regulatory approval has been obtained where required, and ensure that the local staff know how to respond to initial requests for information from the local regulator or tax authority.

- **Prepare detailed central support and documentation** – at a minimum, taxpayers should have a detailed and robust central documentation outlining the approach to identifying service charges, the allocation keys used, the mark-up applied and lots of detail on the nature of the services provided and how they benefit group companies that pay for them. This will not be a 5-10 page document.
- **Manage expectations** – making sure that all relevant internal stakeholders understand that is necessary to have a central service charge policy in place but that it is likely that the group will be challenged by a tax authority or regulator at some time and that the group is prepared for those challenges when they arise.
- **Consider whether to prepare detailed local supporting documentation** – which would involve interviewing local staff and collating local supporting documents. In most cases, because of the time requirements involved, this will only be appropriate when an audit begins and/or when there is a high probability that an entity will be audited in the near future.
- **Consider whether to get a local advance ruling** – which may be appropriate in rare cases where the transactions are particularly large and/or where the group decides to get a ruling in one country to provide a precedent to help support other group companies.

Whilst managing head office and shared services transactions is rarely an easy task, having a well thought through strategy, preparing in advance, retaining documentation and managing stakeholder expectations - can minimise the disruption that comes from the tax authority and regulatory challenges that are bound to arise.

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