Insurance Tax Highlights – Asia Pacific

India

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India – Recent developments

Backed by the strongest mandate in decades, the newly formed Indian government unveiled its maiden budget on 10 July 2014. In his budget speech, the Finance Minister (FM) proposed several policy changes, including those relating to tax policies.

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In this article, we highlight some of the changes and also, recent tax controversies and litigation around some of the issues, which have an impact on the insurance industry in India.

The article covers the following topics:

1. The proposed hike in the Foreign Direct Investment (FDI) limit
2. Transfer pricing related developments, specifically
   a. Enhancing the Advance Pricing Arrangement (APA) programme
   b. Introducing the range concept and use of multiple year data
   c. Expanding the definition of deemed international transactions
3. The requirement to deduct tax at source from sums paid under a life insurance policy
4. An update on the Foreign Account Compliance Act (FATCA)
5. An update on the Common Reporting Standard (CRS)
6. Litigation around the availability of input tax credits on service tax paid under a reverse charge mechanism

1. The proposed hike in the FDI limit

Under the present FDI policy, there is a 26% foreign investment limit in the insurance sector under the automatic route (i.e. non-approval route). This is the composite investment limit for foreign direct investment and investments by Foreign Institutional Investors and Non-resident Indians.

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This year's budget proposed to increase this composite cap from 26% to 49%, through the government route with full Indian management and control. The proposal is pending legislative approval and is likely to come up for approval in the next session of the Parliament scheduled in the later part of 2014.

While the legislative assent is eagerly awaited, there are certain policy related aspects which require clarity. The increase in FDI is subject to meeting the condition of full Indian management and control. However, it is unclear what 'full management and control' actually means.

Typically, in insurance joint ventures, the foreign partner brings domain experience and the Indian partner brings knowledge of the Indian market and relationships with government and regulators. To ensure control, foreign partners generally have a decisive say in key matters like board composition, business plan, appointment of senior personnel like CEO, change in capital structure, etc.

It is possible that the government may align the meaning of 'full management and control' with the present FDI policy where 'control' is defined to mean a right to appoint the majority of directors or to control the management or policy decisions including by virtue of their shareholding or management rights or shareholders agreement or voting agreement.

Against this backdrop, the government may place conditions such as Indian promoters having the right to appoint the majority of directors or that the majority of directors are Indian citizens (such as in the case of the telecom sector) or key positions such as the chairman or managing director or CEO or CFO or actuary be held by Indian citizens.

However for now, we will have to wait for the fine print of the policy to assert what is contemplated by 'full Indian management and control'.

Separately, foreign partners may have to examine the existing terms of the joint venture / shareholders' agreements with respect to management and control, exercise of veto rights, call and put options for changes in shareholding pattern, agreed valuations, etc. This emphasises the need to evaluate the options for an increase in FDI, for proper planning and structuring of the investment proposal, keeping in mind various tax and regulatory aspects. This is crucial as any proposal for an increase in FDI has to withstand the government approval process.

2. *Transfer pricing related developments*

As mentioned above, the budget proposed to increase the composite cap of foreign investment in the insurance sector from 26% to 49%[1]. This could lead to substantial capital infusion in Indian insurance companies from their overseas associated enterprises (AE). Once that happens, one can expect an increase in intercompany transactions such as capital infusion, reinsurance, intragroup support services, etc. between Indian insurance companies with AEs. Accordingly, it is advisable for Indian insurance companies to plan the intercompany pricing of their proposed transfer pricing (TP) arrangements.

In his budget speech, the FM also proposed some of the much awaited transfer pricing legislation amendments, which were subsequently enacted into law. These amendments, as discussed below, apply in general to most tax payers and are not specific to insurance companies.

a) Enhancing the Advance Pricing Agreement (APA) programme

The APA programme was introduced in 2012 with a view to provide tax certainty and reduce TP related litigation in respect of taxpayers' international transactions. In order to provide further certainty and to align the regulations with the global best practices, the government has introduced 'a roll back' mechanism in the current APA scheme. Thus, an APA, subject to prescribed conditions[2], may also cover four years preceding the first year of the APA. This amendment is effective from 1 October 2014. Insurance companies in India could consider applying for APAs to take advantage of the roll back mechanism and seek to obtain relief on past transfer pricing matters that have been the subject of TP litigation.

Furthermore, given the proposed increase in the sector cap, a substantial capital infusion is expected in Indian insurance companies from their overseas associated enterprises (AE). This is expected to lead to some level of TP scrutiny considering that the Shell and Vodafone cases still await resolution before the Courts, on the taxability of 'issue of shares' controversy, which still remains unsettled. In such share issue / capital infusion cases, the tax authorities have challenged the share issue price determined by the taxpayer and alleged that the difference between the share price determined by the taxpayer and that determined by the tax authorities should be brought to tax as capital gains in the hands of the Indian company issuing the shares to its overseas AE. In view of this, insurance players in India may consider obtaining certainty on the TP method and share price on share issue transactions by adopting the APA route and avoid extensive litigation on such transactions.

b) Introduction of range concept and use of multiple year data

The Indian TP regulations prescribe the arithmetic mean (AM) for determining an arm's length price. In order to align the regulations with global best practices, the Indian government has introduced the concept of a 'range' for which rules will be prescribed[3]. However, it seems that the current AM concept will continue wherever the number of comparable is inadequate.

1 Pending necessary legislative approval
2 Awaiting detailed rules
3 Awaiting detailed rules

To address the use of multiple year data versus single year data dispute between the taxpayers and the tax authorities, the government has proposed to amend the regulations [4] to allow the use of multiple year data. Both the above proposed amendments would provide Indian taxpayers including India insurance companies more flexibility in using comparable margins to justify arm's length nature of transactions.

c) Expanded definition of deemed international transactions

Presently, transactions between the Indian taxpayer and an unrelated person are deemed to be an international transaction with an AE if there was a prior agreement in relation to the transaction between the unrelated person and the AE, or the terms of the relevant transaction are determined in substance between the unrelated person and the AE.

The above provision has led to doubts as to whether or not the unrelated person should also be a non-resident for the transaction to be treated as an international transaction. The government has now clarified this and provides that any transaction between a taxpayer and an unrelated person that satisfies the abovementioned conditions shall be deemed to be an international transaction, whether or not such unrelated person is a non-resident. This amendment is applicable to transactions entered on or after 1 April 2014. So in the future, insurance players in India would need to be cognisant of this extended definition so as to be able to identify and report such deemed international transactions in their TP filings, to mitigate any non-reporting penalty exposure.

3. Deduction of tax at source from sums paid under a life insurance policy

The budget also introduced a new provision (section 194DA) which is now part of the existing tax law. Under the provision, any person responsible for paying to a resident any sum (including bonus) under a life insurance policy, which is not exempt under the provisions of the Act, needs to deduct tax at the rate of 2% [5]. The requirement to deduct tax at source (TDS) is triggered in cases where the aggregate amount of such payments made during the financial year is Rs. 1 lakh or more. This provision is effective from 1 October 2014.

Under the existing tax law (section 10(10D)), any sum received under a life insurance policy is exempt, subject to meeting certain conditions. One of the conditions is that the premium payable for any of the years during the term of the policy does not exceed 10% of the minimum amount assured under the policy on the happening of the insured event at any time during the term of the policy.

In ensuring compliance with the above provisions, there are several issues faced by the industry players which need to be clarified. Some of the key issues are highlighted below.

- The term 'life insurance policy' has not been defined in the Act nor has it been defined under the insurance law. Due to this, it is unclear whether the above provision would also apply to sums paid under products such as pension policies, annuity policies, health policies, various group plans, etc.

- Also, in the case of policies where the policyholder chooses the 'top-up' or 'rider' option whereby an additional sum may be assured upon payment of a 'top-up' or 'rider' premium, it is unclear what amounts should be considered for comparing the minimum premium paid at any time during the term of the policy with the minimum sum assured at any time under the policy, so as to determine the eligibility for exemption.

To seek clarity on these issues and to ensure compliance with the TDS provision, representation has been made on behalf of the industry by their representative body (Life Insurance Council) with the tax administrative body i.e. Central Board of Direct Taxes (CBDT). The industry is hopeful that the CBDT will issue the necessary guidance on these issues soon.

4. FATCA

In April 2014, the Indian government in substance agreed to the terms of the Inter-Governmental Agreement (IGA) between India and the US with respect to the implementation of FATCA. Though the agreement is yet to be formalised by the Indian government and the US Internal Revenue Service (IRS), this is said to have effect from 11 April 2014. This agreement will have a binding effect on certain Indian Financial Institutions including those entities of the insurance sector that are required to make payment with respect to cash value insurance contracts and annuity contracts.

On 21 July 2014, the Insurance Regulatory and Development Authority issued a circular to all Indian insurance companies excluding general insurance companies advising them to register with the US IRS by 31 December 2014 and obtain a Global Intermediary Identification Number. This time limit would also be applicable to Indian insurance companies having overseas branches in Model 1 jurisdictions (including those jurisdictions where an agreement under Model 1 has been reached in substance). Overseas branches of Indian insurance companies in jurisdictions having an IGA 2 agreement or in a jurisdiction that does not have IGA but permits Foreign Financial Institutions to register, may register with the US IRS before 1 July 2014, to avoid withholding under FATCA. The above conditions shall be applicable to parent entities that are required to register by virtue of their branch entities.

4 Awaiting detailed rules

5 Plus applicable surcharge and cesses

5. *CRS*

Similar to FATCA, the CRS seeks to implement an automatic exchange of tax information in order to monitor financial accounts of a taxpayer in the country in which income arises and transmitting that information to the resident country of such taxpayer. India has committed to implementation of the CRS and is one of the 47 countries to have signed the Declaration on Automatic Exchange of Information in Tax Matters earlier this year. While the CRS is set to be operationalised from 2016 onwards, insurance companies would to need examine the impact of this new regime and determine the action points to be taken to adapt to the new laws.

6. *Availability of input tax credit of service tax paid under reverse charge mechanism*

In India, analogous to GST or VAT levied globally, service tax is levied on all activities in the nature of services. Service tax is levied on all services provided in India, except those services which are specifically excluded or exempted.

Ordinarily, under the Service Tax Law, a service provider is required to discharge the service tax liability. However, in certain specified situations, the service receiver has to pay the service tax as if he/she is the service provider. Such a tax charging mechanism is customarily known as the 'reverse charge mechanism'. One such notified service is the service provided by insurance agents to insurance companies. Accordingly, in the case of services provided by insurance agents, the insurance company is liable to discharge the service tax liability. Once service tax is paid, the insurance companies can avail input tax credit of the service tax paid under reverse charge, which can be utilised to offset other service tax liabilities of the insurance companies.

Lately, insurance companies have been under the scrutiny of the service tax authorities. Most of the insurance companies in India have a commercial arrangement with their insurance agents wherein the service tax liability is either partly or fully borne by the insurance agent i.e. though the insurance companies pay the service tax to the government under the reverse charge mechanism on behalf of the insurance agent, the service tax amount is reduced from the brokerage or commission to be paid to the insurance agent. Additionally, the insurance companies have also been availing input tax credit for the entire service tax paid to the government under the reverse charge mechanism on behalf of the insurance agent.

Various service tax audit notices have been issued to the insurance companies with respect to such arrangements. The notices object the availment of input tax credit to the extent of service tax being borne by the insurance agent. Even though the litigation for these notices is in its nascent stages, given the stakes involved it will take a long time to settle the matter.

In a nutshell

These developments have presented opportunities and also thrown up challenges for the insurance industry. Given the newly formed government's approach and initiatives towards forward looking tax policies, the insurance industry can hope for better days ahead.

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