THE COST OF INDIRECT

Errors in the management of indirect taxes can have a direct impact on the financial performance of your business, as Mike Stalley explores.

In recent years, UK insurance premium tax (IPT) has moved from being of minimal focus to front and centre in the continuing political debate over taxation. Over the same period, many other countries have introduced value added taxes for the first time. It would appear that the levels of indirect taxation, globally, are on the rise.

Margins are squeezed

Within the insurance industry, indirect taxes such as VAT and IPT have a greater than usual impact on company performance.

Across the European Union, insurance transactions are VAT exempt. Whilst this means that VAT is not added to the insurance premiums charged to policyholders, it also means that insurers are unable to recover in full the VAT costs that they incur. Additionally, IPT is levied on insurance premiums charged to policyholders, increasing the cost of insurance coverage.

Unlike corporation taxes, which are calculated based on the profits generated by a business, indirect taxes such as VAT and IPT can directly impact the level of profitability achieved by a business.

These "point of sale" taxes, if managed poorly, can have a material impact on the financial performance of an organisation. If profits go down, there should be a comparable reduction in corporation taxes; however, if revenue has remained constant the amount of indirect taxes payable may well remain the same, squeezing profit margins ever tighter.

A risky business

In my opinion, the management of indirect taxes by an organisation requires a much greater level of involvement from the operational business units. Decisions made around the selling of their products have a direct impact on the level of indirect tax to be levied and the cost of any compliance errors. This risk is amplified when you consider the global marketplace, which increases the cross-border tax issues associated with selling products and services.

Using the insurance industry as an example, simply selling insurance products and then letting the tax team "figure out the premium taxes" creates a huge potential tax risk. Pricing decisions made without reliable tax information can lead to tax errors. If such issues are not identified and corrected until after the transaction has been completed, this will result in tax errors which typically have to be borne by the insurer.

Many larger insurance companies write multinational insurance programmes, effectively insuring the international/global insurance risks of its policyholder clients. In doing so, they are required to manage their exposure to premium taxes, VAT and other indirect taxes in multiple territories. The risk of error is increased every time the territorial scope is expanded, as the need to interpret and make decisions about other countries' tax codes is required. These decisions often need to be made quickly in order to either win the business, retain the business or incept the policy before the renewal date.

In many cases, the insurer is also the party responsible for calculating premium taxes, charging them to policyholders, collecting the taxes and ultimately settling them with the relevant tax authorities. Accuracy is crucial, as small tax errors can have a disproportionate impact on financial performance.

© iStock.com/Gwengoat

TAXATION

MIKE STALLEY, FCA

Chief executive, FiscalReps

The cost of an error

The UK insurance market in recent years has achieved on average a combined ratio of 95%, meaning that for every £100 of premium income written, the insurer makes an underwriting profit of £5.

However, you should then consider that the standard rate of IPT in the UK is now 12% and the average rate in Europe is above 15% (the standard rate in Germany is 19%, Netherlands 21% and Italy 21.25%). You can immediately see that rates of premium tax are greater than profit margins.

An insurance company writing £500m of premiums across Europe will have a potential exposure to premium tax of £75m (using the 15% average rate of IPT). If everything is done correctly, then the exposure is reduced to zero; however, small tax errors can quickly impact underwriting profits.

A tax error of, say, 10%, or £7.5m, equates to 30% of the underwriting profit of that insurer in a single financial year. If the error were to go unchecked for a number of years, the financial impact in the year uncovered could be substantially more, especially if you factor in interest and penalties. Tax authorities' statutes of limitations vary across Europe with four to six years being the norm.

When performance bonuses, stock options and share prices are all dependant on profits, who would want to be in the shoes of the CFO having to report this tax error to the board?

What I believe has made the problem worse for insurers is that investment income has been subdued in recent years, as a consequence of the sustained low interest rates; and insurers need to invest in more low-risk asset classes, as a consequence of increased capital and regulatory requirements. Typically, underwriting losses can be sustained if investment returns are good, but if investment returns are poor the ability to suffer underwriting losses is tested.

And when you add in the irrecoverability of VAT, which is a constant problem for insurers, margins can get squeezed even tighter.

Managing exposure to premium taxes

In the countries that levy insurance premium (or similar) taxes, a number of steps can be taken to manage your exposure to premium taxes.

1 Know your business

Premium tax regimes often include multiple taxes and tax rates, which are applied based on the type of insurance coverage provided. Motor policies often attract different rates of premium taxes to property or liability coverages.

It is essential that a clear understanding of the risks being covered is obtained so that the correct rates can be correctly identified. This can be a problem with complex multinational insurance programmes but underwriters and tax managers must work together to reach a point of certainty.

2 Locate the risks

Location of risk rules exist so that it can be determined which countries' tax rules apply to the premium being charged. If the policy is multinational, it will be necessary to allocate the premium across countries, as the risk will exist in more than one country.

An understanding of the location of risk rules of each country is vital, especially as legislation can sometimes overlap, meaning that double taxation (i.e. the same tranche of premium is subject to the tax laws of two different countries) can sometimes exist.

3 The devil is in the detail

Like VAT, premium taxes are, at a strategic level, simple to identify and calculate. However, with multiple taxes, multiple rates, a myriad of exemptions and a clear lack of harmonisation internationally, the application of the various rules can be difficult, leading to the incorrect taxes being applied.

Furthermore, taxes are subject to change all too frequently, with the UK being the best example with three rate changes in two years. Keeping an accurate record of all current rates is essential for reducing the chances of tax error.

4 Timing is everything

Premium taxes, like VAT, are a point of sale tax meaning that the date of the transaction determines when the taxes must be brought to account. Unlike direct taxes, indirect taxes are typically settled on a quarterly (or even monthly) basis, so it is essential to file and pay the right taxes in the correct periods to ensure compliance.

With the rules surrounding premium taxes lacking harmonisation from country to country, it is crucial that the correct tax point information is gathered and stored so that compliance can be achieved.

A desire to comply

My experience of dealing with insurers for nearly 15 years is that they want to be tax compliant and do not choose to pursue aggressive tax mitigation strategies, where avoidance and evasion can overlap. That being said, we still encounter non-compliance issues with insurers; however, in the main they are as a consequence of gaps in their systems and processes, rather than being driven by a desire to bend the rules.

The problem does remain, however, that "accidental" errors in the management of indirect tax exposures can have a direct impact on the bottom line. A relatively small investment of time and money, directed wisely, can have a real positive impact to a business's overall financial performance.