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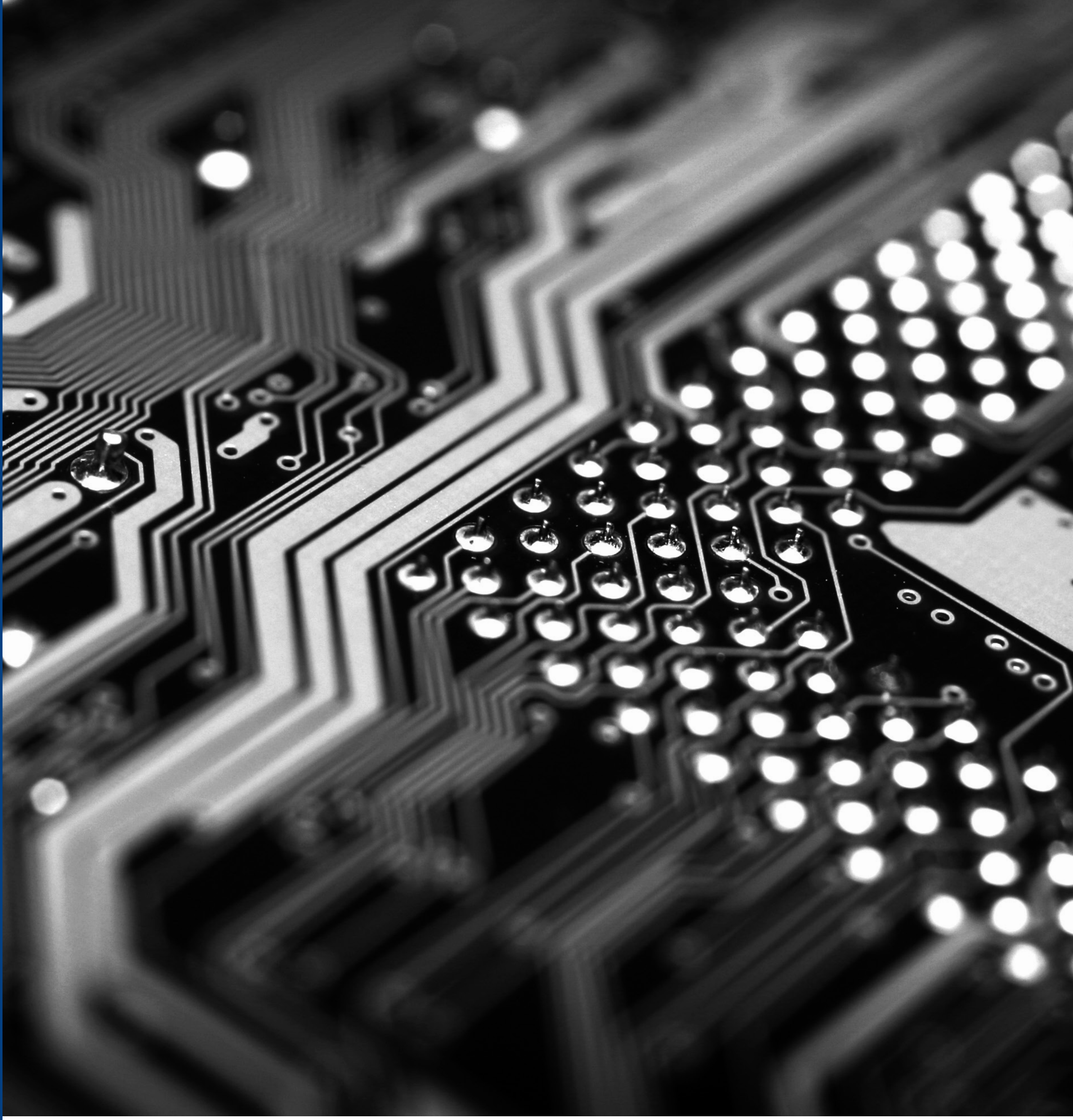

In this week's Insurance Bulletin:

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GEOFFREY CONLIN
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1. REGULATION AND LEGISLATION

Brazil: Concern at tax issues for admitted reinsurers in Brazil

Recent changes to the Brazilian tax rules have significant implications for reinsurers which have established representative offices in Brazil.

Under the Brazilian reinsurance regulatory framework, the market comprises three different categories of reinsurer - local, admitted and occasional - each with different licensing and capital set-up requirements and each subject to different risk cession rules and taxation requirements. There are currently approximately 16 local reinsurers in Brazil, 38 admitted reinsurers and 82 occasional reinsurers. Lloyd's of London has admitted reinsurer status.

In Private Letter Ruling (PLR) No. 62/2017 dated 20 January 2017, the Brazilian Tax Authority (RFB) ruled that representative offices established in Brazil by non-resident reinsurers (so-called admitted reinsurers) should be treated for tax purposes in the same way as a reinsurer incorporated in Brazil (i.e. a local reinsurer). This was primarily on the basis of the RFB's decision that the representative offices of admitted reinsurers are to be considered a permanent establishment, and therefore subject to the same taxation applicable to local reinsurers. In the RFB's view:-

"… the activities of representative offices do not have the character of mere brokerage, preparatory or ancillary services, but are characterized for tax purposes as equivalent to provision of services by local reinsurers."

The local representative office of an admitted reinsurer is a service office, with all underwriting and claims handling being carried in the overseas office of the admitted reinsurer. Premium flows direct from the cedant insurers to the overseas entity and not via the account of the local representative. The practical effect of elevating the tax status of admitted reinsurers to local reinsurer is potentially very significant in terms of tax exposure.

Each corporate entity is structured differently and will have its own unique tax arrangements; however, by way of illustration, under the usual regime, local and admitted players have been paying tax on the following basis since the opening of the Brazilian reinsurance market in 2008.

- Local reinsurers pay 45% corporate income tax plus 4.65% PIS/COFINS (i.e. federal contributions for funding social security) on gross premiums. The corporate income tax is comprised 15% tax on net profit plus an additional 20% by way of social contributions (CSLL). Local reinsurers with net profit in excess of BRL240,000 (approximately USD75,000) pay an additional 10% tax.
- Local representative offices of admitted reinsurers pay 34% corporate income tax and are generally exempt from PIS/COFINS on service fees received from the admitted reinsurer. The corporate income tax is comprised 15% tax on a profit which is calculated on the 'cost plus' basis (usually 15%) plus an additional 9% for social contributions (CSLL), together with the 10% uplift for admitted reinsurers with net profit in excess of BRL240,000.
- The office of the admitted reinsurer which is based overseas is subject to the tax regime of the jurisdiction of domicile; however it also pays 2% on premium (which is calculated at 25% of a presumed profit of 8%) as withholding tax. There is also a 0.38% IOF tax on the exchange rate conversion.

The effects of the ruling are not entirely clear. In principle, it represents an 11% percent increase in the rate of corporate income tax for the local representative office of admitted reinsurers, plus the application of 4.65% PIS/COFINS. However, the ruling also raises difficult questions about application, not least because it anticipates taxing the local service office for the gross premium generated by admitted reinsurers even though, as set out above, these payments are not channelled through the account of the local representative and are normally taxed overseas.

The new ruling is also problematic because it is binding as of the date of its issuance and it is generally not subject to appeal. It is also potentially retrospective for five years, since it is not a new law but the clarification of an existing law. Furthermore, in the event the local representative offices of admitted reinsurers cannot calculate their profit under the rule on a retrospective basis (which is difficult since by its nature it is a service office) the default position is that it could potentially pay tax at a rate for 'arbitrated profit' of 45% on turnover, pursuant to a separate Brazilian tax regulation.

At the end of June 2017, a meeting took place between representatives from SUSEP, Fenaber and the tax regulator. Although no formal written decision has been made, there is some hope that these three entities may arrive at a consensus whereby the status quo prior to the publication of the PLR will be re-instated, however the timeline for any definitive solution is likely to be lengthy.

In the meantime, admitted reinsurers conducting business in Brazil have been advised to revisit their current activities, agreements, practices and guidelines to assess the scope of the powers of attorney of their representatives in Brazil vis-à-vis this PLR, in particular in the interests of narrowing down or limiting the scope of such powers (legal footprint, scale and scope of operations, assets and headcount in the ground in Brazil). The consensus is that this could assist reinsurers in any potential litigation.

The decision has done much to further shake the confidence of international investors in the Brazilian reinsurance market. Some admitted reinsurers may consider scaling down their operations and focusing their resources on other Latin American jurisdictions like Chile where doing business is much easier, and Argentina, which is under-going positive regulatory change. This recent tax development has also led to speculation that the three license model is coming under pressure. The recent IPO of the IRB may also change the dynamics in the sense that there may be greater emphasis on the free market, which would be welcomed by the international investment community.

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2. MARKET DEVELOPMENTS

UK: New combined insurance product for law firms

A new insurance product, which combines cyber and crime cover with professional indemnity insurance protection required by the SRA, has been created for law firms by Locktons. The new "interlocking" policy has been developed in a bid to respond to the growing threat to law firms posed by criminals as well as the need for law firms to protect their risk profile in response to the introduction of new regulatory obligations.

According to the British Chamber of Commerce, one in five businesses have been the victim of cyber attacks in the past year. Within an 18 month period, £85 million was stolen by hackers from law firms; three quarters of the cyber crimes reported to the SRA in 2016 were some form of "Friday afternoon fraud", and £7m of client losses resulted from email hacks in relation to conveyancing transactions. The cyber cover offered under the new product includes protection for breach of privacy, business interruption, media risk, malicious code, cyber extortion and claims expenses. The new product covers funds held both in office and in client account from both external and internal threats, including cyber-related crime.

Until the introduction of the new product, law firms needed to take out separate policies to cover different risks. This led to the possibility of disputes between insurers as to which policy responds to a loss, and resultant delays for the policyholder. The new product aims to avoid this, and allows policyholders to report and deal with cyber breaches efficiently without needing to activate multiple policies.

CIARA JACKSON
ASSOCIATE

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ALISON PROCTOR
SENIOR ASSOCIATE

"In recent years, cyber insurers' focus has been on increasing their market share by offering additional cover and favourable terms in their policies at relatively low cost. Now we are seeing insurers taking a tougher approach."

It will be interesting to see the uptake of the new product, and whether similar interlocking/combined products will be created for other industry groups.

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UK: A change in approach by cyber insurers

Insureds need to take a careful look at the cyber cover being offered by insurers, and make sure that they are aware of the implications of what is and is not on offer.

The EU's General Data Protection Regulation (which comes into force in May 2018) and Network and Information Systems Directive (currently under consultation) indicate the beginning of a stricter regulatory regime as regards data protection. This, together with a maturing market and increased market sophistication, could have a significant impact on insureds in that it looks set to lead to cyber insurers to seek to reduce cover and adopt a hardened attitude to claims.

In recent years, cyber insurers' focus has been on increasing their market share by offering additional cover and favourable terms in their policies at relatively low cost. Now we are seeing insurers taking a tougher approach. One example of this is notification periods. Traditionally cyber policies provided insureds with long periods in which to notify claims. More recently, the trend has been for policies to require immediate notification and to make this a condition precedent to liability.

Similarly with the scope of cover available. Insureds are increasingly finding that insurers are insisting on problematic exclusions being included in their policies, for example the CL380 exclusion clause, which means that there is no cover for a potential computer hacking event. In the light of recent high profile hacking stories, this is arguably a must have cover.

Cyber risk can take many forms, and cannot always be quantified in terms of monetary losses. Brand reputation is increasingly at risk and cyber cover should include property damage cover for both hardware and software, business interruption, cyber crime, cyber extortion, reputational damage and privacy and security liability cover.

It is critical for insureds that they are aware of their exposures and what is and is not covered by their policies, particularly in the light of the ongoing developments in and increasing sophistication of the cyber landscape.

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3. HFW PUBLICATIONS AND EVENTS

UK: HFW to host London Insurance and Reinsurance Group

On Tuesday 26 September, HFW London will host the London Insurance and Reinsurance Group quarterly meeting. Partner Andrew Bandurka will chair, and Partner Costas Frangeskides and Senior Associate Matthew Wilmshurst will give a presentation on the Hanjin Insolvency. Costas Frangeskides will then give an update on recent legal decisions of interest to the London Market. Enquiries to antonia.munro@hfw.com

UK: HFW at the Falconbury Advanced Reinsurance Wordings Course

On Thursday 28 September in London, Partner Andrew Bandurka will chair the Falconbury Advanced Reinsurance Wordings Course, and lead a session on "Drafting Watertight Reinsurance Clauses", and Partner Christopher Foster will lead a session on follow the settlement clauses.

Saudi Arabia: HFW at the Institute of Finance Emerging Risks Workshop

On Monday 18 September, Partner John Barlow will be speaking on Political Risk and Trade Credit at the Emerging Risks Workshop at the Institute of Finance in Riyadh.

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