



Discussion Draft of the Report on the Attribution of Profits to a Permanent Establishment

Part IV (Insurance)

Note to Business Commentators

The Discussion Draft of Part IV (Insurance) of the Report on the Attribution of Profits to a Permanent Establishment is released for public comment for the first time. Comments should be submitted no later than 16 September 2005. Depending on the comments received a decision will be taken on whether it would be useful to have a face to face discussion with business commentators.

Comments are particularly invited on the following issues:

- The factual accuracy of the analysis of the most important functions of the modern insurance industry.
- The impact of regulation, and in particular host country regulation, on the conduct of insurance business.
- The commercial rationale for internal reinsurance within a single enterprise.
- The use of alternative risk transfer mechanisms, such as catastrophe bonds.
- The types of risk which require surplus and how to determine the quantum of surplus and its location within a single enterprise.
- Other issues as identified within the body of the Report.

Commentators should be aware that the Working Party No. 6 is still processing the substantial business comments received on draft Part I. The final conclusions on Part I may impact upon the finalisation of Part IV. However, in view of the importance of receiving business input on the issues set out above that are specific to the insurance sector, it was decided to release Part IV now, without waiting for the finalisation of Part I.

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PREFACE

1. The permanent establishment (PE) concept has a history as long as the history of double taxation conventions. Currently, the international tax principles for attributing profits to a PE are provided in Article 7 of the OECD Model Tax Convention on Income and on Capital, which forms the basis of the extensive network of bilateral income tax treaties between OECD Member countries and between many OECD Member and non-member countries.

2. There is considerable variation in the domestic laws of OECD Member countries regarding the taxation of PEs. In addition, there is no consensus amongst the OECD Member countries as to the correct interpretation of Article 7. This lack of a common interpretation and consistent application of Article 7 can lead to double, or less than single, taxation. The development of global trading of financial products and electronic commerce has helped to focus attention on the need to establish a broad consensus regarding the interpretation and practical application of Article 7.

3. As a first step in establishing a broad consensus, a Working Hypothesis (WH) was developed as to the preferred approach for attributing profits to a PE under Article 7. This approach built upon developments since the last revision of the Model Commentary on Article 7 in March 1994¹, especially the fundamental review of the arm's length principle, the results of which were reflected in the 1995 OECD Transfer Pricing Guidelines (the Guidelines). The Guidelines address the application of the arm's length principle to transactions between associated enterprises under Article 9. The basis for the development of the WH was to examine how far the approach of treating a PE as a hypothetical distinct and separate enterprise could be taken and how the guidance in the Guidelines could be applied, by analogy, to attribute profits to a PE in accordance with the arm's length principle of Article 7. The development of the WH was not constrained by either the original intent or by the historical practice and interpretation of Article 7. Rather the intention was to formulate the preferred approach to attributing profits to a PE under Article 7 given modern-day multinational operations and trade.

4. To meet the policy goals described above, the WH was tested by considering how it could be applied in practice to attribute profits both to PEs in general and, in particular, to PEs of businesses operating in the financial sector, where trading through a PE is widespread. A Discussion Draft containing the interim results of testing the application of the WH to PEs in general (Part I) and to PEs of banking enterprises (Part II) was released for public comment in February 2001. Twenty five responses were received from the business community, banking associations and advisory firms, reflecting a diversity of views and interests. Because of the variety of positions expressed and the complexity of the issues, a consultation was held in Paris in April 2002 with the commentators on the Discussion Draft. The consultation was very valuable as it allowed the identification of common ground in terms of principles, of areas that needed further clarification and of areas where further work was needed.

5. A revised Part II and a Part III (Global Trading) were released for public comment on 4 March 2003. Nineteen responses were received from the business community, banking associations and advisory

¹ This revision followed the publication of "Issues in International Taxation No. 5: Model Tax Convention: Attribution of Income to Permanent Establishments".

firms. Again because of the complexity of the issues, a second consultation was held in Geneva in March 2004 and a meeting with selected commentators held in Paris in October 2004. It is expected that Parts II and III will be finalised in 2005. A Revision of Part I was released in August 2004, which takes account of the comments received and the discussions during both consultations.

6. The testing of the WH is reaching its conclusion and sufficient progress has been made in the development of the WH to mean that the WH has now become the authorised OECD approach. This draft (Part IV) completes the testing process by describing how the OECD authorised approach would apply to attribute profits to a PE carrying on insurance business.

DISCUSSION DRAFT ON THE ATTRIBUTION OF PROFITS TO A PERMANENT ESTABLISHMENT – PART IV (INSURANCE)

A. INTRODUCTION

1. Part I of this Report sets out the principles of the authorised OECD approach and provides guidance on the practical application of these principles to attribute profits to a permanent establishment (PE) in general. However, it is also considered necessary to supplement this general guidance with more specific and practical guidance on the application of the authorised OECD approach in commonly occurring factual situations. Parts II and III of this Report discuss special considerations in applying the authorised OECD approach to PEs in the context of traditional banking businesses and global trading in financial instruments. This Part of the Report (Part IV) looks at the insurance industry and discusses how the authorised OECD approach applies to a number of factual situations commonly found in enterprises carrying on an insurance business through a PE. More specifically, Part IV applies the authorised OECD approach to the operation of property and casualty insurance, life insurance, and reinsurance activities.

2. The insurance industry presents a number of unique challenges to tax authorities. Traditionally, the nature of the on-going relationship created by insurance resulted in customers dealing largely with domestic insurers with whom they were comfortable. However, the insurance industry rapidly is becoming more global. Cross-border merger and acquisition activity is increasing, which will result in greater consolidation of the industry. As a result, tax authorities may find it difficult to find useful comparable transactions for the purpose of doing a transfer pricing analysis. Insurance companies may find it advantageous to operate through PEs in a number of jurisdictions, rather than through subsidiaries, because certain host state regulators rely on regulation by the home state. Host states may not have developed rules for attributing profits to such PEs, or there may be questions about whether those rules, where they exist, are fully compatible with their existing treaty obligations.

3. Finally, many companies are exploring the use of electronic and faxed communications, or the Internet, to issue policies cross-border without establishing physical PEs (the activities may nevertheless constitute a PE under Article 5 depending on the particular facts and circumstances).

4. Part B of this Report provides a functional and factual overview of an insurance business. Part C briefly discusses how to apply the Guidelines to insurance business conducted between associated enterprises. Part D discusses how the authorised OECD approach applies to a PE of an enterprise carrying on insurance business. Part E discusses whether Article 7(4) should be deleted from the OECD Model Tax Convention. Finally, Part F discusses Article 7(7).

B. FACTUAL AND FUNCTIONAL ANALYSIS OF AN INSURANCE BUSINESS

B-1. General Overview

5. The insurance business is the business of accepting and managing risks of losses arising from the realisation of events outside the control of the insured. Insurance businesses are able to accept and manage the risks of losses by pooling those risks among many risk averse persons via the payment of an amount by the insured to the insurer, called a premium (see paragraph 7 below for a description of how losses can arise in different types of insurance business). In consideration of the payment of the premium, when the insured incurs a loss or a specified event occurs he or she is indemnified for the amount of the value of his or her loss or receives an agreed payment or service.

6. The pricing of the premiums must take into account both the absolute amount of expected losses of the pool of insured persons and the time when claims are expected to be paid. The insurer will invest premiums to earn a return, and this return will be taken into account in the insurer's calculation of the appropriate level of premium.

7. The term "risk" may have different meanings and it is important to differentiate between risks of losses to which the policy holder (premium payer) may be exposed and the risks assumed by an insurance corporation in accepting and managing those risks. For the rest of this document, the term "insured risk" refers to the potential losses insured by the insurer (the very essence of the business of insurance) and the term "risk" refers to the risks assumed by insurers in accepting and managing insured risks.

8. In accepting and managing insured risks, risk is assumed by the insurer to the extent that there is potential for actual claims to exceed expected claims. This risk is called insurance underwriting risk. There are other kinds of risk that the insurer faces that are discussed in section B-4(i), below. To the extent that an insurer assumes underwriting risks, it will command a risk premium that will compensate it for the risks it is assuming. Thus for an insurer that takes on very risky forms of insurance, the premium required by the insurer will be higher than for less risky forms of insurance.

9. Three parts of the insurance industry can be distinguished and are the focus of this Report: the life and health industry (usually referred to as the "life" or "long term" insurance industry), the property and casualty industry (usually the "P&C" or "general" industry) covering all insurance business other than life or health, and the reinsurance industry. Life insurers concentrate both on replacing the financial loss resulting from the death or illness of individuals, and providing savings products. P&C insurers generally insure the risk of financial loss arising from damage or loss of property through fire, theft or third party liability. Reinsurers provide insurance on risk of underwriting loss for both P&C and life insurers.

10. An insurance enterprise may be organised in one of many possible legal forms. The enterprise can take the form of stock insurers (those with share capital), mutual insurers (no share capital; policyholders are effectively the owners), co-operatives (such as farmer co-operatives), and fraternal benefit societies (which may typically be created by athletic associations, religious or ethnic groups).

11. Insurance businesses may organise themselves in foreign jurisdictions in both subsidiary and PE form.

i) Income and Capital (Surplus) in the Insurance Business

12. Two important sources of income for insurers are underwriting and investment income. Insurance premiums are set at a level that covers the insurer's expected costs of claims, its costs of administration

(including sales commissions) its expected investment return and a profit return. The amount of expected profits will vary according to the perceived degree of risk for the different lines of business. Underwriting income is the insurer's net income from the pure insurance elements of its business, being the balance found after deducting expenses and claims (including any movement in provisions for outstanding claims) from the premium income. It does not include investment returns (income and gains on investment assets). Insurance companies hold substantial amounts of investment assets. These assets may arise from premiums received from policyholders in exchange for insuring risks (referred to as reserves) and from capital provided by stockholders (referred to as surplus).

13. In the case of life insurance, it may be more difficult to separate profit into underwriting and investment components due to the long-term nature of the business, especially in jurisdictions where the enterprise is not required to report the two separately in their financial statements. In addition, life insurers may earn fees on non-insurance related business, such as the administrative services provided on large group health plans. Another source of income for insurance companies may come from providing "fronting services", such as underwriting and claims administration, to offshore captives.

14. Insurance contracts give rise to loss payments that may not be realised for many years, while the premium income received from those contracts and associated with those future expenses is received and reported as income in the current year. But a substantial portion of the income is simply to fund future expected loss payments. Accordingly it is appropriate to set aside an amount to reflect the future payment in the form of a reserve. Since this reserve is for a future claim payment it is a liability to the insurer. An attempt is made to place the insurer's income on an accrual basis by matching the timing of the inclusion of premiums in income with the timing of the deduction from income for the reserve.

15. The nature of insurance business (the acceptance and management of insured risks) creates a requirement for surplus to absorb any losses in excess of reserves from the realisation of those insured risks. Surplus may also be used to support product development, marketing, and other functions depending on the nature of the business. Capital means the equity of an insurance company, but the term has a multitude of facets. It is used as an accounting term (paid-in capital and accumulated profits or losses not distributed to shareholders). It is also extremely relevant for regulatory purposes (often referred to as "surplus" or "free assets") and is defined under the various country specific regulatory provisions. It is also used in connection with creditworthiness (ratings issued by independent rating agencies to indicate level of financial strength to clients and creditors), which is particularly important for long-term business (also see Section B-4(ii) which discusses the importance of creditworthiness).

16. Throughout Part IV of this Report, equity capital in the insurance industry will be referred to as "surplus". Surplus includes paid-in capital of shareholders plus any accumulated profits (or losses) not paid out as dividends. The insurer, in order to be able to accept and manage insured risks, must have surplus, and the amount of surplus it has determines the amount and type of insured risk it can accept and manage. Both the market-place and the regulators determine the amount of surplus required in order to undertake insured risks in various lines of business.

17. This Report seeks to provide guidance on how to determine which part of an insurance enterprise performs the various functions involved in the acceptance and management of insured risks (and so should receive the associated insurance underwriting income). It also acknowledges that insurance companies may provide services other than pure insurance, for example the administration of medical plans or asset management services. Guidance will also be provided on how to determine an appropriate attribution of surplus and reserves to the various parts of the enterprise, taking into account any regulatory conditions imposed by the host country, thereby determining the attribution of the assets representing that surplus and reserves and the associated investment income.

ii) *Role of Reinsurance*

18. Reinsurance is a mechanism through which insurers can manage risks by shifting or ceding one or more insured risks to reinsurers in exchange for payment of premiums. As a result of the reinsurance, the ceding company may reduce or credit its reserves for the insured risks ceded to the reinsurer. Its assets may also be reduced by the amount of the consideration paid to the reinsurer for accepting those insured risks. Accordingly, reinsurance agreements reduce the risk assumed by the insurance company, thus alleviating the requirement for surplus with respect to the insured risks. It should be noted that even if all the insured risk were to be reinsured, some risk would remain to the original insurer, e.g. the credit risk that the reinsurer does not pay up under the reinsurance contract. This default risk has led some regulators to limit the amount the insurance liabilities can be “credited” for the ceded insured risks; i.e. the amount by which the technical reserves are reduced. By allowing insurers to tailor their insured risks, reinsurance plays an important role in the efficient functioning of insurance markets.

19. A reinsurance contract is an agreement between an insurer and a reinsurer. The insurer writes the policy for the policyholder and is contractually responsible for any payments to the policy holder that come due under the policy, even if those insured risks are eventually covered by another insurer as part of a reinsurance contract. The insurer markets the policy, bears the costs of its sale and on-going administration and receives the premium income associated with the policy. In a reinsurance contract, the insurer (cedant) cedes the insured risks to a reinsurer in return for the payment of the reinsurance premium. In return, the cedant receives a payment (referred to as a ceding commission) intended to cover the portion of the costs that it incurred in obtaining the policy and to produce a profit. The result is a net payment made by the cedant to the reinsurer.

20. Reinsurance agreements can take several forms including:

- *Facultative reinsurance* which is a basic form of reinsurance agreement in which the reinsurer assesses each insurance policy before agreeing to reinsure the insured risk. Facultative reinsurance is typically used for very large single insured risks.
- *Treaty reinsurance* which is a basic form of reinsurance agreement in which a contract for some fixed period of time (e.g., *one year*) is undertaken whereby the reinsurer agrees in advance to accept a specified amount of all insured risks or losses defined in the treaty, for example, from a particular line of business. A reinsurer will base its willingness to accept the insured risk upon the experience and reputation of the ceding company. Under either type of contract, the reinsurer and insurer share insured risks on some agreed basis. There are two main types of insured risk sharing arrangements:
 - *Proportional reinsurance (or quota-share reinsurance)* is an insured risk sharing arrangement where the reinsurer reinsures a certain percentage of each of the policies written by the ceding company during the term of the contract. This kind of reinsurance can be used when the capital available to the insurer is limited relative to its capacity to market policies.
 - *Excess of loss reinsurance* is an insured risk sharing arrangement that provides that the reinsurer will pay the ceding company to the extent that the ceding company’s losses from a particular line of business exceed a certain amount.

This sub-section only discusses the situation whereby reinsurance takes place between independent legal enterprises. Issues relating to reinsurance between associated enterprises within the meaning of Article 9 of the OECD Model Tax Convention are dealt with in Section C. Section D-2 (iii) discusses the difficult

question of internal reinsurance, i.e. where one part of the enterprise purports to reinsure the insured risks accepted by another part of the same enterprise.

B-2. Functions performed

21. This section analyses the most important functions of a traditional insurance business. Following the approach in Chapter I of the Guidelines, the analysis of functions performed also takes into account the assets used and risks assumed in performing those functions. The focus of the discussion in this section relates primarily to the functions performed in a property and casualty business. However, most of these functions are also performed by life insurance and reinsurance companies, to varying degrees.

[Views from business are invited on the factual descriptions of the functions of an insurance business in this section]

22. The operational functions are the functions that must be performed in order for an insurance enterprise to intermediate insured risk. The following sub-section describes the most important operational functions of a traditional insurance business.

(i) Functions of an insurance business

23. The functions are discussed in this Report in terms of a value chain describing the key business processes in the insurance industry starting with the development of the insurance product and ending with administration of claims made under the insurance policy and the long term investment of the assets supporting the insurance liabilities. There are other functions related to management and support processes, e.g. planning, human resource management, etc. but only those particular to the insurance industry are discussed in this Report. The functions comprising the business process are similar for each of the three parts of the industry listed above (life, P&C and reinsurance), but the relative importance of each function may vary considerably from one category to the next and between different businesses and lines of business. When the functions are generally more important in one category of insurance, that importance will be highlighted in the following sections but it should be stressed that the relevant importance of these functions will vary according to the particular facts and circumstances of each taxpayer.

a) Product management/Product development

24. This process comprises the risk-technical, legal and mathematical structuring of the product. In concrete terms, it means assessing the quantitative, qualitative, geographical and time-related features of insurance cover in the context of insured risk assumption and savings/dissaving processes. In addition, it involves determining the scope and features of advisory and processing services. The structuring of insurance products must be adapted on an ongoing basis in line with developments in the market, in legislation (including tax legislation) and in claims performance.

25. Important processes of product development involve the following activities: market research, gathering and maintaining (claims) statistics, legal stipulation of the extent of cover, mathematical calculation of the premium depending on the features of insurance cover (geographical, temporal, insurance excess options, etc.). In recent years, the function of product development has increased in importance owing to the sharp jump in the scale of competition. In the case of re-insurers, product development vis-à-vis the customer is likely to be relatively uncommon.

26. The assessment of risk and pricing/setting of premiums for new lines of insurance may be performed by the underwriters. In some cases arm's length third parties may perform some of these functions by providing specialist services to insurance companies. For example, some organisations compile claim statistics and make them available to member institutions. Other enterprises use proprietary mathematical models and processes to produce data for use by their clients in estimating the cost of claims resulting from the weather (flooding, hurricanes, hail, etc) or other events. Brokers may provide market analysis and research and structure programs to meet client needs.

b) Sales and marketing

27. At first, the general marketing strategy is defined, based on a process that allows identification and analysis of client needs. The marketing strategy is segmented into products, regions, countries etc. The marketing strategy also encompasses the definition of marketing and acquisition programs, and the development and application of training and educational programs.

28. At the sales stage, the client's risk of losses and requirements are analysed and a suitable proposal is made. In certain business lines (e.g. life insurance), risks of losses and financial security problems are increasingly linked to a multitude of legal parameters of a judicial and fiscal nature, and consumers are frequently overwhelmed when it comes to formulating their security needs. In these lines the advisory function is increasingly important, and the advisory process should be seen as a component of the actual market service regardless of how this added value is organised (in-house or independent sales force, brokers, internet methods, etc.). The various sub-processes involved in sales, marketing and acquisition include acquiring clients, assessing requirements, advising clients and providing quotes and proposals.

29. An insurance contract guarantees the fulfilment of a function over a contractually agreed period of time. The prospect of entering into a longer-term relationship leads to an extension of the business effort beyond the time of the actual sale of the service by providing sales/support functions. The Customer Relationship Management services area's task is to strengthen client relationships, even if no claims payments are made in a certain period. Key functions in the "CRM" field include: ongoing analysis of the client's risk situation, adjusting requirements, preventing termination, utilising cross-selling opportunities, handling complaints, etc. Customer relationship management potentially benefits insurance companies in a number of ways. It may help reduce persistency ("lapse") risk (specific risks are commented on in B-4) encountered in the life insurance industry by encouraging policyholders to not lapse or terminate their policies. It may reduce underwriting risk by providing direct claims experience with the policyholder over longer time spans. It may also assist the insurer in differentiating itself from other insurers thus lowering marketing costs/efforts. There also are risks to the insurance enterprise if the sales and marketing functions are not properly performed so that its products are mis-sold to a customer, e.g. the risks were not properly explained to the customer or the product was not suitable.

30. Insurance agents and brokers undertake sales and marketing function by trying to cultivate potential clients and to create client relationships. The exact nature of this function depends on the type of insurance, e.g. life insurance is aimed at the retail market and so the nature of the marketing function will be quite different from that of a reinsurer where the market is other insurance companies. The relative importance of the function will also depend on the facts and circumstances. For example, for some products that are intrinsically profitable in insurance terms, e.g. travel insurance, the marketing function is likely to be important, whilst for other products such as credit card insurance the development of a customer relationship will be vital. To carry out the sales and marketing functions, many insurers rely on independent agents and brokers; others rely on their own sales staff including those of other companies, such as a bank, in a financial group. There is a growing trend to selling directly by phone and the Internet.

In general, brokers act as an intermediary and represent the insurance buyer. Agents represent the insurance company. In the case of reinsurance, the broker's client is the insurance company (cedant). The use of brokers may be more prevalent in the large commercial and reinsurance market segments whereas agents may be found more frequently in small commercial risks and personal lines. The significance of each of these distribution channels may also vary by country as well as by geographic region.

31. Companies in the international property and casualty business and the reinsurance business rely very heavily on unrelated brokers to sell insurance. In many cases, these unrelated brokers are under fiduciary obligations to act on behalf of clients and buy insurance from many insurance companies. Such brokers may perform underwriting type functions, by gathering information relevant to the insured risk and preparing the preliminary terms of a contract. In some cases, the brokers have authority to bind insurance companies, provided that the prospective insured satisfies a specified risk profile. Thus, in many cases, brokers perform functions that go beyond sales and marketing.

c) Underwriting Insured Risk

32. Underwriting is the process of selecting and pricing the insured risks to be accepted. Again, the exact nature and importance of the function will vary depending on the type of insurance product and the facts and circumstances of the taxpayer. For example, the underwriting function is likely to be less important for certain types of standardised products and for reinsurance where, respectively, marketing and risk management/reinsurance functions may be more important. There are a number of activities that can be labelled as "underwriting" but it will be important in the factual and functional analysis to distinguish between the following aspects.

- *Setting the underwriting policy.* Defining an underwriting policy which the underwriters have to follow is part of risk management. The underwriting policy will set the parameters for determining the amount of risk to undertake and also is designed to ensure that the insurer writes a book of business that is profitable and reasonably stable.
- *Risk selection and pricing.* The process of selecting and pricing the insured risk is underwriting in a narrow sense. The underwriter analyses the specific risk and related risk category, and determines the pricing according to risk, cost and market conditions. Further, the underwriter selects the risk and verifies capacity limits. The basic requirements are the classification of risks on the basis of selected criteria and the use of relevant statistics.
- *Acceptance of risk.* The decision to enter into the contract is the underwriting activity that exposes the enterprise (and its surplus) to insured risk.

33. The objective of underwriting is not the selection of insured risks that will not generate losses but to avoid the misclassification of insured risks according to the pricing of insurance contracts. Defining an underwriting convention or practice which the underwriters have to follow is part of risk management. The underwriting policy will set the parameters for determining the amount of risk to assume and determines the nature and size of business of an insurance company and is the major factor affecting the profitability of insurance operations. Five major factors influence the underwriting policy;

- (1) the financial capacity of the company
- (2) the regulatory framework concerning the maximum production capacity
- (3) the technical skills and abilities of personnel, and
- (4) the availability and cost of reinsurance

(5) strategic business goals

34. The basic requirements are the classification of insured risks on the basis of selected criteria and the use of relevant statistics. For standardised products, this procedure may be to a certain extent automated. In the case of complex contracts, the process is very complex (comprehensive insured risk verification) and requires very strong specialist skills (insured risk engineering, explanation of judicial, medical, physical implications, etc.). In particular, the following sub-processes are involved in executing the contract: processing the proposal, underwriting insured risk, preparing the contract, commissioning. These activities are carried on largely by underwriters but require the assistance of other personnel such as actuaries (e.g. to assist with pricing and assess the likelihood of claims), legal staff (e.g. for contractual advice) and support staff for administrative matters.

35. Underwriters may be located in the Head Office of the insurer or in the PE depending on the product line involved. This underwriting may be split on the basis that the Head Office provides broad underwriting practices to be followed by the PE while the PE performs the underwriting decisions of individual risks. In the case of large or specialized policies, the Head Office may be performing the underwriting. Even when the underwriting occurs in the Head Office, there may be situations where there is a need for an underwriter in the PE to attend the client business; with a sales agent to make a presentation or just to get a better understanding of the risk involved in the client's business. It may be necessary to determine, through a functional and factual analysis, where the underwriting function is being performed and the value of that function in the particular circumstances.

d) Risk management and reinsurance

36. The overall risk of an insurance company is comprised of several factors (underwriting risk, commercial risk, environmental risk and investment risk). Underwriting risks are usually the decisive factor, although market investment risk is an important part of insurance business, particularly in the case of life insurance companies. These risks include asset default, reinvestment, and volatility risk). The different risks are traditionally dealt with independently. To manage these risks, insurers have a comprehensive range of risk management tools (underwriting policy, premium policy, claims adjustment policy, portfolio policy, reinsurance policy, investment policy). The calculation of premiums and the analysis of the claims experience (probabilities, claims distribution, etc.), the setting of investment assumptions, as well as setting aside the necessary reserves, are the tasks of insurance actuaries.

37. The risk management function also comprises the capital management, i.e. establishing and maintaining a capital management process (including the setting of target rates of return on capital and monitoring progress against those targets), performing the capital allocation to the various lines of business and parts of the organisation (considering, among others, the different solvency regulations and capital requirements). Accordingly, capital management and allocation is a highly complex area.

38. Of central importance to this value added process is the function of reinsurance. It involves the partial transfer of the underwritten insured risks to a reinsurer. Key components of this process are: analysis of the insured risk portfolio, establishing the reinsurance requirements, negotiating, structuring and concluding agreements with the reinsurer, financial execution of the reinsurance transaction, ongoing co-operation with the reinsurer (managing statistics, distributing information, etc.). Often, multinational insurance companies use internal reinsurance to improve the financial efficiency of reinsurance. They deploy internal reinsurance to their PEs, thus gathering together the insured risks against which external reinsurance is applied. The value of internal reinsurance within a single enterprise would have to be determined through a factual and functional analysis since, on a consolidated basis, there is no transfer of

risk outside the enterprise. This issue is further discussed in Section D-2 (iii) below. Reinsurance between associated enterprises is discussed in Section C.

39. Over and above this traditional form of risk transfer, new methods of risk financing have been discussed and employed for some time now (ART: Alternative Risk Transfer). The multitude of innovative approaches are firstly aimed at overcoming the barriers to insurability and secondly at optimising the management of the underwriting risk from the point of view of both diversification and cost. The essential feature of ART products appears to be that they import the techniques of the capital markets into insurance through securitisation, often through use of special purpose vehicles to issue securitised financial products. The most common form of securitised insurance product is the catastrophe (cat) bond. This offers a high coupon subject to a specified but infrequent insurance event e.g. an earthquake. If the event occurs the investor's return is reduced or eliminated and in the riskier bonds part or all of the coupon (and possibly part of the principal) may also be lost.

[Factual information is invited from business on the use of alternative risk transfer mechanisms (including the use of special purpose vehicles to issue catastrophe bonds)]

f) Contract and Claims Management

40. This function includes the monitoring of a contract over its entire life cycle, i.e. maintaining the information on contractual developments, insured risk and occurrences, as well as maintaining accounts on premiums, claims reserves and commissions. It also includes the loss and claim reporting process - the establishment and maintenance of a loss reporting system, developing reliable claims statistics, defining and adjusting claims provisions and introducing measures to protect and reduce claims in future). Claims management includes all the activities related to a client's claim including, processing the claims report, examining cover, handling the claim (working out the level of the claim, clarifying causes, claims reduction measures, legal analysis) and seeking recovery.

41. In today's competitive environment, insurance companies may also provide tangible and intangible emergency help (assistance, replacement in kind, physical/emotional help for clients) in addition to the purely financial settlement. This can be one way for an insurance company to differentiate itself from its competitors in an attempt to gain market share.

h) Asset Management

42. In insurance it is important to match the maturity of asset portfolios with liabilities over a long term period. Asset management comprises the short term asset allocation, security selection, and investment accounting. Short term asset allocation is the definition of investment policy within the boundaries of the longer term asset allocation policy. Security selection is limited by both long term and short term asset allocation decisions, and is determined by analysing the relevant sectors and regions. Investment accounting is the accounting backbone of asset management, ensuring proper recording and performance monitoring.

43. Investment advisors carry out the asset management functions of the insurance business. They make investments out of the reserves and surplus that the company maintains, and monitor the risks associated with those investments. In the property and casualty industry they tend to work independently of the underwriters and marketers and since they don't have to interact with the companies clients they can be located far from them. In the life industry the insured may have more control over the investments made so that the connection between the client and investment advisor is closer and requires closer proximity.

Investment advisors work with the regulatory compliance personnel since the risk associated with assets is closely monitored by regulatory agencies.

44. Asset management may be carried out in whole or in part by third parties. This may be the case even for large insurance companies with their own in-house asset management group.

i) Support processes

45. An insurance business will also have to undertake a number of support functions some of which are particular to the industry, while others are of a more general nature. Important support functions include:

- *Treasury functions.* The Treasury monitors the timing of income from investments to make sure that the cash flow is appropriate to pay projected claims. It hedges investments again in order to make sure that cash flow is secure and to make sure that the timing of investment income meets the cash flow requirements. It is generally responsible for cash management such as borrowing funds on the most advantageous terms possible. The relationship or distinction between this function and the asset management function would have to be determined through a factual and functional analysis.
- *Regulatory compliance* (e.g., monitoring assets and liabilities, often on a daily basis to make sure that surplus requirements of regulators are met).
- *Systems and development of intangibles* (e.g., development of information technology and systems that can be used to determine pricing and calculate reserves, advertising).
- *Other back office* (e.g., accounting, auditing, legal services, training).
- *Loss control* tries to prevent those losses that can be prevented and to minimise those that cannot be prevented. The loss control department provides input to the underwriters and marketers.
- *Credit analysis* assesses the credit worthiness of the enterprise's various counterparties, including reinsurers, policy holders and persons in whom investments are made.

46. As can be seen from the previous sub-section, there are a number of functions necessary to undertake an insurance business. It will be important to identify not just what functions are performed (taking into account assets used and risks assumed) but also their relative importance. The functional and factual analysis will therefore have to identify the most important risks for the particular taxpayer and which functions give rise to those risks.

47. Clearly the determination should be on a case-by-case basis as the relative importance of a given function is likely to vary according to facts and circumstances, e.g. product differences, type of business, business strategies etc.

48. One area of particular significance for types of insurer that focus on accepting complex insured risks is the identification of the functions which create the greatest value and risks. Such functions require two key decisions: (1) the decisions as to what insured risks to accept and on what terms; and (2) which of those insured risks to retain and which to reinsure. However, the relative significance of a given activity for a particular enterprise depends upon such factors as the type of insurance operation and the business model employed. As always the analysis depends on the facts and circumstances of the individual case. For

example, the complex insured risks functions are likely to be far more important for complex risks such as life or earthquake insurance than for standardised products such as travel insurance sold over the internet.

B-3. Assets used

49. The Guidelines note at paragraph 1.20 that compensation will usually reflect not just functions performed, but also assets used and risks assumed in performing those functions. So the functional analysis will have to consider what assets are used and what risks are assumed in creating, and subsequently managing an insurance contract. For insurance companies, the most important assets used are financial assets, such as bonds, stocks, and cash. However, investment in real estate assets is also important especially for long-term business. These assets are used by the insurance company to generate investment return in the form of interest, dividends, rents and capital gains.

50. Insurance companies also use physical assets such as sales offices, claims offices, information processing centres, etc. and so the functional analysis will have to consider which non-financial assets are used by the PE. Section C-2 (iv) of Part I of this Report provides some guidance in this area. These assets may need to be taken into account in making any comparability analysis under the second step of the authorised OECD approach. For example, selling insurance through the internet may be substantially less expensive than selling insurance through a broker or agent, or even directly by phone, because no physical facilities or personnel may be required to make internet sales.

51. Further, as with any other business, the functional analysis should also examine whether any intangible assets have been used. In the insurance business, common intangibles are marketing intangibles represented by the name, reputation, trademark, logo, and sales force in place of the insurance company. Insurance companies also may have licenses to sell insurance in various markets that are intangible assets obtained at the cost of complying with regulatory licensing procedures. Other intangible assets would be more akin to manufacturing intangibles, such as underwriting tools/tariffs and proprietary systems for efficiently managing insurance contracts and monitoring insurance and financial risks.

B-4. Risks Assumed

52. This section discusses the various types of risk assumed as a result of the performance of the various functions necessary to undertake an insurance business. Part II of this Report noted (paragraph 11) that, “the issue of capital is linked inextricably with the issue of risk assumption” and went on to note that, “[T]he analysis of risks assumed would include an examination of the issues related to capital adequacy and allocation of capital that are likely to be of particular significance for banks and other financial institutions.” In the context of an insurance business, this section therefore goes on to discuss issues related to the requirement for surplus, other regulatory requirements, and the effect of reinsurance.

i) Types of Risk

53. The acceptance and management of insured risks creates or generates additional risks that regulators require the insurance enterprise to maintain surplus to support. Aside from direct business risks, significant risks to insurers are generated on the liability side of the balance sheet. These risks are referred to as technical risks and relate to the actuarial or statistical calculations used in estimating liabilities. On the asset side of the balance sheet, insurers incur market, credit, and liquidity risk from their investments and financial operations as well as risks arising from asset-liability mismatches. The principal types of risks are as follows.

a. Underwriting risk is the risk that there is potential for actual claims to exceed expected claims. Underwriting risk varies by line of business and its related “tail” (“tail” refers to the lag between the policy inception and loss payment dates.) i.e. short-tail lines such as auto collision generally have a tail less than two years whereas long-tail lines such as commercial liability may have a tail of 10 to 15 years. This risk may include as components/factors:

- Cumulations risk - (storm, quake, flood, hail)
- Geographical diversification
- High parameter risk – uncertainty over the true value of expected losses
- Adverse Selection – Occurs when the insurer cannot distinguish between the probability of a loss for good and poor risk categories. If an average probability of loss is used to set a premium those at the highest risk will be the most likely to purchase coverage.
- Moral Hazard – Occurs when an insurer cannot predict the behaviour that will result from providing insurance coverage to an individual. An individual could act with less care, for example, and if data from uninsured individuals is used to estimate rates then premiums could be too low to cover losses.
- Correlated Risk – Occurs when there are many simultaneous losses from a single event – such as an earthquake.

b. Risks associated with investment activities that might affect the coverage of technical provisions (the amount set aside on the balance sheet to meet obligations arising out of insurance contracts including admin expenses, embedded options, dividends to policy holders or bonuses and taxes) and/or solvency margins (capital), include:

- Market risk, also referred to as investment yield risk, relates to the ultimate amount of investment income that will be earned on the assets resulting from the investment that the insurance business makes. Since the income from assets provides an important part of the income needed to pay policyholder claims, the risk of low returns to investments makes an important claim on the insurer’s surplus.
- Credit risk is the risk that the amounts due to the insurer may not be paid. The types of credit risks include:
 - *Asset credit risk* – the risk that the insurer will not receive a return or indeed a repayment of the capital on its investments due to the person receiving the investment failing to pay.
 - *Reinsurance credit risk* – the risk that the amounts to be paid by the reinsurer to the insurer under a reinsurance contract may not be fully collectible.
 - *Instalment payment risk* (including retrospective premiums) – the risk that the insured will not be able to pay the premium to the insurer.
- Concentration risk which may arise from the limited availability of suitable domestic investment vehicles.

c. Risks associated with risk management and reinsurance include:

- Basis Risk – an imperfect correlation between actual losses caused to the insurer and the payments received from a CAT bond.

- Intertemporal Basis Risk – the risk associated with changes in the book of business from the time when the model was used to price the policy
- Retrocession risk – insurance on reinsurance – the transfer of ceded premiums to other reinsurers or primary insurers – creates credit risk and the possibility of a domino effect in the event of failure by the end insurer.

54. As well as the risks assumed as a result of performing functions relating to underwriting, investment, and risk management as noted in the previous paragraph, an insurance enterprise is also exposed to other types of risk and to operational risk. Operational risk is the risk that a business may incur liabilities in connection with its business activities. Operational risk includes liabilities arising from employees making errors in judgement, being negligent or careless, and conducting illegal or improper activities while acting within the scope of their employment. Recent examples (e.g. selling of products with a guaranteed rate of return that the insurance company cannot achieve in a low inflation environment) highlight the importance of managing this risk as failure to do so can lead to the effective bankruptcy of the insurance enterprise.

55. Examples of other types of risk include:

- *Foreign exchange rate risk.* An international insurance company may have substantial foreign exchange rates risk. This is the risk that foreign exchange rates fluctuate compared to the balance sheet currency. Insurers generally seek to manage currency risk, including by using natural hedges, such as holding reserves and surplus in the currency of the jurisdiction in which the PE is located
- *Liquidity risk* - the risk that assets need to be liquidated at unfavourable conditions if cash is needed immediately to meet unexpected obligations to policyholders. The latter risk is typically managed using an appropriate asset-liability management.
- *Reputation risk* – in many markets intermediaries serve as important distribution channels of insurance – an interface between consumers of insurance and providers of insurance. Their conduct may impact the insurer.
- *Some risks particular to the Life Insurance lines:*
 - Asset default risk - the risk of loss resulting from on-balance sheet asset default and from contingencies in respect of off-balance sheet exposure and related loss of income
 - Mortality risk – the amount and timing of death benefits paid
 - Longevity risk – increase in longevity increases the cash flow due to annuity payments
 - Persistency/lapse risk – if policy holders surrender their policies before prepaid (front end loaded) expenses are recovered – correlation with interest rates creates interest rate risk and market systematic risk
 - Cash flow risk – policies contain embedded options i.e. to offset minimum interest payment guarantees etc
 - Segregated funds risk - the risk of loss arising from guarantees embedded in segregated funds.

(ii) *Creditworthiness /Solvency margins*

56. As noted in Parts I-III, creditworthiness is an important condition for all enterprises, in particular those in the financial sector. For an insurance business, solvency margin (the surplus of assets over liabilities) is likely to be a particularly important measure of creditworthiness. Third parties doing business with the insurance enterprise would be concerned that the insurance enterprise will have sufficient financial resources to meet claims when they arise in the future. This is particularly important in the more

long-term types of business, e.g. life insurance, where considerable periods of time might arise between the acceptance of the insured risk and the event triggering a claim.

(iii) *Surplus Requirements*

57. As noted in Parts I-III, capital is an important condition for all enterprises, in particular those in the financial sector that accept and manage financial risks in the ordinary course of their business. In the context of insurance, the capital required in order to assume the risks described above is commonly referred to as surplus. Minimum levels of surplus are required by regulatory agencies based upon the lines of business of the insurer.

iv) *Other Regulatory Requirements*

58. Regulators not only regulate the amount of surplus required to do insurance business, but also may regulate:

- the relative amounts of types of investments that can be made based upon the market risk of those investments and the lines of business conducted by the insurer and sometimes the pricing of contracts,
- the types of products or lines of business that can be sold, and
- the amount and timing of the reserves that are to be taken against future losses or claims.
- where there is specific host country regulation, this may also determine not just the amount of surplus, types of investment etc but also their location, e.g. by requiring specific assets to be held in the host country.

59. In some jurisdictions, local insurance regulators require a foreign company to maintain assets in a local trust as a condition of conducting an insurance business in that jurisdiction. These “trusteed assets” generally must be sufficient to support the foreign company’s activities in that jurisdiction. Typically, the trusteed assets are equal in amount to the PE’s regulatory reserves and minimum surplus. The PE generally must obtain permission from insurance regulators to remove the trusteed assets and the trusteed assets may only be used to pay the PE’s liabilities. Thus, the trusteed assets are not available to pay other obligations of the foreign insurance company.

60. In some cases, a foreign insurance company reinsures insured risks in a country but is not licensed to do business in that country and may not have a PE in that country. Local insurance regulators may not allow a domestic company to claim credit (reduce regulatory reserves) for reinsurance purchased from the unlicensed foreign insurance company unless the foreign company places assets supporting the reinsurance contract in a trust fund. The trust fund typically holds assets at least equal to the amount of the regulatory reserves supporting the insured risks reinsured under the contract.

v) *Effect of Reinsurance*

61. Reinsurance provides a means for freeing up surplus that will allow the insurance enterprise to take on other types of insured risks. Since regulators are responsible for assuring that a minimum level of surplus is available to support the risk assumed by an insurance business they are very concerned with credit-worthiness of the reinsurer and its ability to fulfil the payments provided for under the reinsurance

contract. If a reinsurer doesn't have the necessary funds to provide payment when the reinsurance policy calls for that payment, the ceding company, in effect has not freed up surplus by entering into the reinsurance contract. Regulators, who recognise this problem, will frequently require that the reinsurer set up a trust or other type of fund that contains the necessary amounts called for in the reinsurance contract. When the reinsurer is in another jurisdiction, the regulator has no control over the financial health of the reinsurer, and thus in some jurisdictions require that such a fund be created in the home country of the ceding company. The creation of a trust or similar type of fund raises a number of issues under the authorised OECD approach (see Section D-1(iii) and D-2(v) (c) for further discussion.

B-5. Agency PEs

62. Insurance companies sell insurance to customers through a number of different marketing channels (i.e., the internet, vending machines, telephone solicitation, etc.). Most insurance is sold through a broker or agent, though in the insurance industry the term "agent" sometimes means simply an employee of the insurance company as well as an agent proper, i.e. someone who is not an employee but who acts on behalf of the company with authority to conclude contracts in the name of the company. In some cases, the broker or agent may only sell policies issued by the company. Alternatively, a broker or agent may be paid on a commission basis and sell insurance policies of a number of different insurance companies. The activities of an insurance company in a foreign country may be limited to selling its products there through brokers or agents paid on a commission basis and complying with various regulatory requirements related to the policies sold (i.e., filing documents with the regulators and establishing trust funds in the country to hold insurance premiums).

63. An insurance company that sells insurance in a country through agents proper may have a PE in that country but only if the activities conducted by those agents falls within the definition of a "dependent agent" under Article 5(5) of the OECD Model Tax Convention. Moreover, an insurance company that sells insurance through an agent of "independent status" would not be deemed to have a PE in that country through the agent's activities provided it is "independent" within the meaning of Article 5(6) of the OECD Model Tax Convention. In short, an insurance company may engage in a large-scale business in a country but not have a PE because it sells insurance exclusively through "independent" agents under Article 5(6). See paragraph 39 of the OECD Model Commentary on Article 5. To obviate this possibility, some bilateral conventions include a provision that stipulates that insurance companies have a PE if they collect premiums in that country through an agent. Again see paragraph 39 of the OECD Model Commentary on Article 5. Discussion of the rules for determining whether an insurance company has a PE in a country through an agent is beyond the scope of this paper. The scope of this paper is limited to considering how much profit is attributable to a PE once a PE has been created through a dependent agent (dependent agent PE) or through a fixed place of business, as defined in Article 5 of the OECD Model Tax Convention.

64. Given the different types of activities that can be carried on through an agency PE, once it has been established that there is a dependent agent PE under Article 5(5), it will be essential to determine the exact functions performed by or through the dependent agent in order that profit can be appropriately attributed to that PE. In particular, a key question will be whether or not the PE is accepting and managing the insured risk, and assuming the associated risks, and therefore requires surplus to be attributed to it. This is discussed in detail in Section D-1(i) d.

C. APPLICATION OF THE GUIDELINES TO INSURANCE COMPANIES OPERATING THROUGH SUBSIDIARIES

65. This Report's description of insurance companies operating through PEs is of assistance in applying the Guidelines to insurance companies operating through subsidiaries. The factual and functional analysis of an insurance business in Section B is applicable both to insurance activities conducted between associated enterprises and to insurance activities within a single legal enterprise. Further, the guidance in Section D on how the Guidelines can be applied, by analogy, to attribute profit to an insurance PE, may also provide useful guidance on how to apply the Guidelines to insurance activities more generally. It is also worth stressing that in this sub-section, the discussion proceeds on the assumption that the arrangements between the associated enterprises have not resulted in a dependent agent (or indeed any kind of) PE under Article 5. This analysis and guidance enables taxpayers and tax administrations to apply the Guidelines to a variety of insurance related transactions between associated enterprises.

66. Reinsurance is the single most important transaction occurring between P&C insurers. A very large percentage of direct insurance is reinsured, and a very large percentage of reinsurance is reinsured once again (retro ceded). This is particularly important in the context of transfer pricing because reinsurance frequently takes place between related parties, for example, between a parent and its subsidiary. These transactions, although between related parties, can have non-tax motivation just as unrelated party transactions have non-tax motivation. For example, an insurance business operating in several jurisdictions each with its own regulatory requirements might use reinsurance transactions to attempt to transfer risks to match the surplus with the regulatory requirements, or to meet exceptional demand for insurance in a given jurisdiction.

67. There can also be tax motivated transactions between related parties. For example, an insurance company may be operating in a high tax jurisdiction and have a subsidiary in a low tax jurisdiction the profits of which the parent can defer reporting in the parent's tax jurisdiction. In such circumstances, the parent company may attempt to move underwriting income offshore and produce underwriting losses for the parent by pricing the premium or ceding commission inappropriately, and/or by entering into ceding arrangements which, viewed in their totality, differ from those which would have been adopted by independent enterprises engaged in the same or similar activities under the same or similar conditions behaving in a commercially rational manner. The objective of the company is to shift funds offshore to avoid tax.

68. An analysis of such related party insurance arrangements could potentially involve the consideration of the Guidelines. An arm's length remuneration is remuneration for functions performed (taking into account assets used and risks assumed). Therefore, an adequate functional analysis being the corner stone of the comparability analysis is the basis for a proper judgement of the arm's length character of the transactions between associated parties. Such an analysis would determine whether or not the parties have entered into ceding arrangements which, viewed in their totality, differ from those which would have been adopted by independent enterprises engaged in the same or similar activities under the same or similar conditions and behaving in a commercially rational manner. Also the place of residence and the assessment of whether or not there is a PE (article 4 and 5 of the OECD Model Tax Convention) could be subject to review; the facts resulting from the functional analysis could also be useful for these purposes. In respect of the Guidelines a threshold issue is whether related party insurance or reinsurance transaction should be recognised (either wholly or partially) as true insurance. That inquiry would be informed by the principles in paragraphs 1.36-1.41 of the Guidelines. Those principles might warrant disregarding the purported insurance or reinsurance transaction in either of two circumstances. The first circumstance might

arise where there were no economic reality to the form of the transaction that putatively insures or reinsures risk solely within a controlled group. The second circumstance might arise where the elements of the transaction, viewed in their totality, differ from those which would have been adopted by independent enterprises behaving in a commercially rational manner, and the actual structure practically impedes the tax administration from determining an appropriate valuation of the transaction.

69. Different jurisdictions have adopted varying approaches to address one or more of the above issues in respect of related party insurance. One approach is to wholly or partially disregard reinsurance of certain business, and instead treat the direct insurer as continuing to earn a specified level of income with regard to the transferred reserves and surplus. Another approach could be to disregard related party insurance in whole or part by applying general principles of economic substance, or specific anti-abuse provisions. Yet another approach may apply the arm's length rules under domestic law as the basis for adjusting the taxation of the domestic and low-tax jurisdiction enterprises participating in these arrangements. Controlled foreign corporation legislation may also apply where controlled foreign corporations undertake the activities in the low-tax jurisdiction. Some jurisdictions impose an excise or consumption tax on premiums paid to foreign insurance or reinsurance companies.

70. A number of developments in respect of insurance activities carried on through associated enterprises should be noted in the course of the PE discussions. The domestic tax treatment of insurance varies considerably between jurisdictions, creating a tax incentive to report income in one jurisdiction rather than another. A number of offshore centres, which impose little or no income tax, have further positioned themselves to attract insurance companies by developing very favourable regulatory regimes. Insurance companies try to make use of these regimes through establishing holding companies there, largely for the purpose of eliminating the application of controlled foreign corporation rules to the overseas operations of the insurance group. Domestic companies may form wholly or partially controlled "captive" insurance companies in low tax jurisdictions and seek to use them to insure risks of the domestic businesses (or to reinsure such risks that are insured in the first instance by unrelated intermediaries, so-called "fronting companies"). In a similar development, domestic insurance enterprises may seek to shift the income attributable to reserves and surplus associated with their direct insurance business to affiliated enterprises in low-tax jurisdictions via reinsurance transactions. For example, a quota reinsurance treaty covering a substantial portion of a domestic insurance company's business may be entered into with an affiliated company. The insurance company could then reinsure a small amount of direct business with an unrelated reinsurer, with the aim of using the comparable uncontrolled price (CUP) method to set the value of the related reinsurance premium.

71. Apart from the threshold inquiry, there could be further areas of analysis under the Guidelines. In the above quota reinsurance example, it would be important to evaluate the comparability of the controlled transaction with the uncontrolled transaction that is put forward as the basis for applying the CUP method. See paragraphs 1.19-1.35 and 2.7-2.9 of the Guidelines. For instance, the significance of the volume differential would need to be considered (see paragraph 2.13 of the Guidelines in relation to the application of the CUP method). Further, while the direct insurer may owe a reinsurance premium to the reinsurer, the reinsurer may owe the direct insurer offsetting compensation for services - e.g., to the extent the direct insurer performs functions, or uses special skills, relationships or intangibles, for the benefit of the related reinsurer. Depending on the circumstances, it may be necessary to use one of the transactional profit methods of Chapter III of the Guidelines, either alone or in conjunction with traditional transaction methods, to provide the best estimation of an arm's length price in the related party insurance transactions.

72. The issues involved in related party insurance and reinsurance are significant and, as discussed, they have been an important focus of domestic taxing authorities. Working Party No. 6 might usefully explore these issues further as part of its monitoring of the Guidelines.

D. APPLYING THE AUTHORISED OECD APPROACH TO INSURANCE COMPANIES OPERATING THROUGH PEs

73. This Section discusses how to apply the authorised OECD approach to attribute profits to a PE of an insurance enterprise. The approach taken is first of all to introduce the basic principles before describing in Section D-1 how the authorised OECD approach would apply generally to insurance businesses. Particular attention is paid to how the transfer pricing concepts of functional and comparability analyses, which are necessary to perform both the steps of the authorised approach, can be applied, by analogy, to an insurance PE. Section D- 2 discusses in detail how this general guidance would apply to specific situations commonly found in the insurance sector.

Basic principles used to attribute profits to an insurance PE

74. For insurance, no less than for other businesses, the key aim is to attribute profits to a PE in accordance with Article 7(2) of the OECD Model Tax Convention. In other words, it is necessary to determine “the profits which [the PE] might be expected to make if it were a distinct and separate enterprise engaged in the same or similar activities under the same or similar conditions”. A PE is not the same as a subsidiary since it is not in fact legally or economically separate from the rest of the enterprise of which it is a part. This is of course a natural outcome, resulting from the decision to operate through a PE rather than a subsidiary.

This section provides an introduction to the basic principles of the authorised OECD approach as applied to insurance PEs. The basic principles described below are discussed in more detail in the rest of the Report.

Functional and factual analysis

75. In the context of the authorised OECD approach, the functional and factual analysis is used to (1) delineate the PE as a hypothesised distinct and separate enterprise engaged in the same or similar activities under the same or similar conditions; and (2) to attribute profits to the PE under Article 7, using the guidance on the application of the arm’s length principle of Article 9 given by the OECD Transfer Pricing Guidelines, by applying these Guidelines by analogy and, where required, by adapting and supplementing these Guidelines to take into account factual differences between a PE and a legally distinct and separate enterprise. The functional and factual analysis will also take into account the assets used and risks assumed as a result of performing those functions. The functional and factual analysis will therefore have to identify the most important risks for the particular taxpayer and which functions give rise to those risks. Of particular importance will be the determination of the key entrepreneurial risk-taking functions of the enterprise and the extent to which the PE undertakes those functions. These key entrepreneurial risk-taking functions are those which require active decision-making with regard to the taking on and day-to-day management of the individual risks and portfolios of risks that have been identified as the most important under the functional and factual analysis. It is these key entrepreneurial risk-taking functions that are likely to impact most directly on the profitability of the insurance enterprise. This is because it is the performance of those functions that leads to the assumption of the greatest risks and therefore the requirement for capital in the form of surplus.

76. It should be stressed that a particular insurance business may have one or more key entrepreneurial risk taking functions, each of which has to be taken into account. Clearly the determination should be on a case-by-case basis as the key entrepreneurial risk-taking functions and their relative importance are likely to vary according to the particular facts and circumstances; e.g. product

differences, type of business, business strategies etc. (see discussion in paragraph 100 below). Such functions require two key decisions: (1) the decisions as to what insured risks to accept and on what terms; and (2) which of those insured risk to retain and which to reinsure. However, whether a given activity constitutes a key entrepreneurial risk taking function for a particular enterprise depends upon such factors as the type of insurance operation and the business model employed. As always the analysis depends on the facts and circumstances of the individual case.

77. Once assets and associated investment income have been attributed to the part of the enterprise performing the key entrepreneurial risk taking functions, it will also be important to reward other functions in accordance with the arm's length principle. It should also be noted that there is no presumption that these other functions are by nature of low value. This will be determined by the functional and comparability analyses based on the particular facts and circumstances. A whole spectrum of rewards from performing these other functions can be expected ranging from, at one end, low value rewards to at the other end rewards based on a share of the residual profit of the part of the enterprise acting as the key entrepreneurial risk-taker. In short, the functional and factual analysis determines the attribution of profits to the PE in accordance with its functions performed, assets used and risks assumed, and informs also the attribution of surplus, reserves and investment income to the PE.²

78. The factual and functional analysis is of critical importance. In attributing profits to a PE it is not sufficient to prepare symmetrically balanced books attributing profits in the books of the PE that correspond exactly to the values used in the books of the head office. Nor is it sufficient to record insured risks and the associated surplus, reserves and investment assets in the books without consideration of where the key entrepreneurial risk taking functions leading to their creation are performed. Book entries must be consistent with, and follow from, the factual and functional analysis. Where this is the case, the books provide the starting point for determining the profits attributable to the PE.

Attribution of investment assets and risks

79. Investment assets and risks will be attributed to the PE in accordance with a factual and functional analysis of the enterprise concerned that, in particular, seeks to identify the key entrepreneurial risk-taking functions. This is because it is the performance of those functions that ought appropriately to be reflected in the attribution of the associated income generating assets, i.e. the assets arising from the investment of the premiums, reserves and surplus associated with those functions and that are required to support the insured risk. The attribution of the income generating assets arising from the investment of the surplus is dealt with in more detail below. This determination should be made on a case-by-case basis as the key entrepreneurial risk-taking functions and especially their relative importance will depend on the type of insurance business particular facts and circumstances³.

80. An insurance company earns income from holding investment assets (i.e. bonds and stocks). In general, investment assets are attributable to reserves (amounts set aside from premiums to pay future claims) and surplus (amounts received from shareholders or earned from operations) held by the company. Thus, the amount of investment income includible in the taxable income arises from investment of the both reserves and surplus held by the company.

81. The amount of an insurance company's reserves (which is equivalent to the liabilities or debt of a bank) is calculated based upon certain assumptions about estimated payouts and interest rates. In general, the investment assets of a company less its reserves (or technical liabilities) will equal the surplus. Thus,

² See paragraph 56 of Part I which describes the fact specific nature of the key entrepreneurial risk taking functions for a given business.

³ paragraph 58 of Part I which describes the consequences of attributing assets to a PE.

the amount of the surplus held by a company is based on the methods used to calculate the reserves. An insurance company may set up large reserves by using very conservative payout or interest rate assumptions. As a result, it does not need to maintain a large surplus. Alternatively, the company may hold small reserves but maintain a large surplus in case those reserves are insufficient to cover its liabilities. The goal is to attribute the appropriate amount of investment assets (both reserves and surplus) to different parts of the enterprise.

82. Countries may have different methods for calculating the amount of reserves that must be maintained for tax purposes. Thus the amount of reserves and related surplus attributable to a PE in the host country may differ from the amount of reserves and surplus determined under the methods applied by the tax authorities in the home office. Part II recognized that for banking enterprises, countries apply different methods to determine what constitutes debt as opposed to capital. Part II accepted that the approach applied by the host country should generally be used to determine the amount of capital attributable to a bank PE. Similarly, in the insurance context, the rules of the host country in which the insurance PE operates would be used to determine the reserves and related surplus of the PE, subject to the conditions set out in Section B-2 of Part I and the discussion in paragraphs 96-98 below.

Attribution of surplus and associated investment assets.

83. The factual starting point for the attribution of surplus to an insurance PE is that the surplus is primarily required to support the risks assumed by the enterprise. This surplus must be regarded as following those risks. In other words, surplus is to be attributed to a PE by reference to the risks arising from its acceptance and management of insured risk, and not the other way round.

84. This attribution of surplus should be carried out in accordance with the arm's length principle, to ensure that the insurance PE, just like any other PE, has sufficient surplus to support the functions it undertakes, the assets it uses and, crucially, the risks it initially assumes and subsequently bears. Until such time as surplus is called upon to meet any excess of claims over reserves it is invested and the income from these investments is attributed to the PE as described above. The Report describes a number of different possible approaches for applying that principle in practice, recognising that the attribution of surplus to a PE is not an exact science, and that any particular facts and circumstances are likely to give rise to a range of arm's length results for the surplus attributable to a PE, not a single figure.

85. The different possible approaches for attributing surplus to the PE all have their strengths and weaknesses in terms of how closely they approximate to the arm's length principle, the relative importance of which will depend on the circumstances. The key to attributing surplus is to recognise:

- the existence of the strengths and weaknesses in any approach, and when these are likely to be present;
- that the key test of the suitability of an approach in any particular case is whether it gives a result that is consistent with the arm's length principle. It may well be appropriate to test this by applying one of the other approaches, to see whether this produces an outcome within a similar range.

Recognition of dealings

86. There are a number of aspects to the recognition (or not) of dealings between a PE and the rest of the enterprise of which it is a part. First, a PE is not the same as a subsidiary, and it is not in fact legally or economically separate from the rest of the enterprise of which it is a part. It follows that:

- all parts of an insurance enterprise have the same creditworthiness, except where due to host country regulation certain assets are held as trustee assets and so can only be used to meet claims in the host country. It means that dealings between a PE and the rest of the enterprise of which it is a part should generally be priced on the basis that both share the same creditworthiness; and
- there is no scope for the rest of the enterprise guaranteeing the PE's creditworthiness, or for the PE to guarantee the creditworthiness of the rest of the enterprise of which it is a part.

87. Second, dealings between a PE and the rest of the enterprise of which it is a part normally have no legal consequences for the enterprise as a whole. This increases the scope for tax-motivated transfers between the two and also acts to reduce the decisiveness of any documentation (in the inevitable absence, for example, of legally binding contracts) that might otherwise exist. It therefore implies a need for greater scrutiny of dealings between a PE and the rest of the enterprise of which it is a part than of transactions between two associated enterprises and places the onus on the taxpayer to be able to demonstrate clearly that it would be appropriate to recognise the dealing.

88. This greater scrutiny means a threshold needs to be passed before a dealing is accepted as equivalent to a transaction that would have taken place between independent enterprises acting at arm's length. Only once that threshold is passed can a dealing be reflected in the attribution of profits under Article 7(2). A functional and factual analysis will determine whether a real and identifiable event has occurred and should be taken into account as a dealing of economic significance between the PE and another part of the enterprise. An accounting record and contemporaneous documentation showing a "dealing" that transfers economically significant risks, responsibilities and benefits would be a useful starting point for the purposes of attributing profits, but would not be determinative. Taxpayers are encouraged to prepare such documentation, as it may reduce substantially the potential for controversies regarding application of the authorised OECD approach. Tax administrations would give effect to such documentation, notwithstanding its lack of legal effect, to the extent that the documentation is consistent with the economic substance of the activities taking place within the enterprise and that it does not violate the principle of the authorised OECD approach by, for example, purporting to segregate risks from functions. For guidance on economic substance see paragraphs 1.28-1.29 and 1.36-1.37 of the Guidelines.

89. In this context it should be recalled that even transactions between associated enterprises may not be recognised where they do not take place under the normal commercial conditions that would apply between independent enterprises (see 1.38 of the Guidelines which discusses the circumstances in which transactions between associated enterprises would be similarly not recognised or would be restructured in accordance with economic and commercial reality).

90. Third, where dealings are capable of being recognised, they should be priced on an arm's length basis, assuming the PE and the rest of the enterprise of which it is a part to be independent of one another. This should be done by analogy, with the Guidelines, following a factual and functional analysis.

Attribution of profits

91. The attribution of profits to an insurance PE on an arm's length basis will follow from:

- the attribution of functions, assets and risks between it and the rest of the enterprise of which it is a part based on a functional and factual analysis, taking account of dealings that can appropriately be recognised and attributing income from the assets arising from the investment of the insurance premiums and reserves

- the attribution of surplus based on the attribution of risks and the subsequent attribution of the income from the assets arising from the investment of the surplus
- the pricing on an arm's length basis of dealings that can appropriately be recognised;
- the recognition of transactions between the enterprise and associated enterprises and independent third parties that are attributed to the PE;
- the determination of comparability between dealings and uncontrolled transactions, established by applying the Guidelines' comparability factors directly (characteristics of property or services, functional analysis, economic circumstances and business strategies) or by analogy (contractual terms) in light of the particular factual circumstances of the PE.

The resulting determination of the profits attributable to the PE reflects both its income and expense from recognised dealings in amounts equal to an arm's length compensation for the functions that the PE and the rest of the enterprise of which it is a part respectively perform, taking into account the assets and risks attributed to the PE and the other parts of the enterprise, achieved by applying by analogy the Guidelines' traditional transaction methods, or, where such methods cannot be applied reliably, the transactional profit methods.

92. The guidance in the Guidelines can be applied by analogy in order to attribute profit to the PE on an arm's length basis, taking into account the principles outlined in the previous paragraph.

D-1. First Step: Determining the Activities and Conditions of the Hypothesised Distinct and Separate Enterprise

i) Attributing Functions, Assets and Risks to the PE

a) General

93. It is necessary under the first step of the authorised OECD approach to hypothesise the PE as a distinct and separate enterprise "engaged in the same or similar activities under the same or similar conditions". As explained in Part I of this Report (see Section C-1), this will be determined by a thorough functional and factual analysis to identify the economically significant activities and responsibilities undertaken by the insurance enterprise as a whole before going on to identify which of those economically significant activities and responsibilities are undertaken by the PE and to what extent. The accounts or books of the PE will be a useful starting point in this analysis but will not be determinative. For example, while taxpayers may show insured risk in the books of a particular jurisdiction, the results of such booking practices should not be respected where they are inconsistent with the functional and factual analysis, such as where the booking location does not perform the key entrepreneurial risk taking functions in respect of the insured risks.

94. Section B above provides a brief general functional and factual analysis of insurance operations which should assist in carrying out the functional and factual analysis of an insurance enterprise. Of particular importance in a PE context is the conclusion that the determination of the key entrepreneurial risk taking functions for a particular business is a matter of facts and circumstances: what is a key entrepreneurial risk taking function in one business will not necessarily be so in another business. Where, for example, a product such as travel insurance is involved, one of the key entrepreneurial risk taking

functions will be the marketing function. The price of premiums for such products is far in excess of the value of the product in pure insurance terms. The lion's share of the premium must therefore be attributed to the marketing function, together with any income generated by investment of that part of the premium. The underwriting function is also a key entrepreneurial risk taking function and the part of the premium that relates to this is attributed to the PE, together with any income generated by investment of that part of the premium (the reserves) and the relatively small amount of surplus required by the regulator.

95. Where on the other hand the insurer focussed on accepting complex insured risks, marketing is less likely to be important and the key entrepreneurial risk taking function is generally the underwriting function given the increased expertise required to properly assess the risks the client wishes to have covered and to determine a premium which will allow the insure to make a profit.

Impact of regulation

96. One question that arises is the extent to which regulation determines where the insured risk is accepted and managed. Consider the following example where the host state (State A) requires the PE of the insurance enterprise to have a licence to conduct insurance business, to hold assets in State A to cover the risks from the policies written under that licence and to show those assets and liabilities on the balance sheet of the PE. Does it therefore automatically follow that the PE in State A should be treated as accepting and managing the insured risk even if in fact all the necessary functions are carried out in the head office and not in State A?

97. The answer is that regulation of itself is not the sole determinant of where insured risk is accepted and managed as the authorised OECD approach ultimately looks to the functional and factual analysis to determine such matters. The position taken under host state regulation would be the starting point of the functional and factual analysis and there would be a presumption that it reflects the actual position. In many cases, there will be a convergence between this presumption and what actually happens because of the impact of regulation on the functions that are likely to be performed by the PE. However, this is a rebuttable presumption and the position taken by the regulator would not be followed if it were found to be inconsistent with the factual and functional analysis.

98. One good reason for treating the position taken by the regulator as persuasive but not determinative is the fact that often there is no host state regulation (e.g. where both home state and host state are within the European Union) or sometimes any regulation at all, e.g. for reinsurance. In such cases, the starting point would be the properly drawn up books and records of the PE and again as noted in Part I these would be followed provided they accurately reflect the functional and factual analysis.

99. The functions performed in accepting insurance liabilities, in managing those liabilities, and managing the associated assets (see Section B above) are performed by personnel. So it should be possible to determine which functions are performed by the PE by considering whether the people performing those functions are located in the PE. Of particular importance will be the identification of the key entrepreneurial risk taking functions and the extent to which the PE undertakes one or more of these functions, as this has consequences for the attribution of assets and risks. It may also be necessary to determine whether some of ancillary or support functions, although performed outside the PE, should nevertheless be taken into account when attributing profit to the PE as being related to, at least in part, the functions and characteristics of the PE. This will be determined by applying the general guidance in Part I of this Report.

100. As well as analysing each of the functions performed by the PE in detail, it is also necessary to consider what assets are used and risks accepted in performing those functions. In terms of assets used, the most important assets, including intangibles have been identified in Section B-3 above. It is not considered

there are any problems particular to insurance which require guidance beyond that found in Section C-3 (iv) (b) of Part I.

101. In terms of risks assumed, the guidance in Part I should be followed. In particular, as noted in paragraph 58, “to the extent that risks are found to have been assumed by the enterprise as a result of a function performed by the PE, the assumption of those risks should be taken into account when attributing profit to the performance of that function by the PE.” This raises the question of what functions of an insurance business lead to the assumption of particular types of risk. In terms of risk assumed, it is the performance of the key entrepreneurial risk taking functions that leads to the assumption of the greatest risk. Consequently, it is the undertaking of the key entrepreneurial risk-taking functions that creates the possibility of significant profit or loss and the need for surplus and reserves. However, it should be noted that the nature of the key entrepreneurial risk taking functions will vary according to the type of insurance business and the facts and circumstances of the taxpayer. For example, functions leading to the assumption of insured risks are likely to be key entrepreneurial risk taking functions for insurers involved in complex risks such as life or earthquake insurance. In contrast, such functions are far less likely to be key entrepreneurial risk taking functions for insurers selling standardised products such as travel insurance sold over the internet, where marketing functions may be the key entrepreneurial risk taking functions leading to the assumption of the greatest risks for such insurers, i.e. that the marketing efforts prove fruitless.

102. Having appropriately determined the functions performed, the assets used and the risks assumed by the PE, the next question is how to attribute profit in respect of those functions. For insurance, a key part of an insurance company’s profits is the investment income from the financial assets purchased with the surplus and reserves. The authorised OECD approach is to attribute the financial assets (and therefore the associated investment income based on where the key entrepreneurial risk-taking functions in respect of those assets were performed (which of necessity implies the capacity to perform those functions). This will give the location performing those functions (the “economic owner”) the income from the financial assets, e.g. the investment income from a government bond, as well as the underwriting income itself.

103. . The profit attributed will also take into account any dealings at arm’s length to reward other parts of the enterprise for functions performed, e.g. for marketing the insurance product and introducing the customer, use of valuable intangibles etc.

104. As noted in Part II of this Report, the part of a banking enterprise performing the sales/trading function would be attributed the financial asset created by the performance of that function (e.g. the loan) where this function was found to be the key entrepreneurial risk-taking function in respect of the creation of that asset and would also have attributed to it the capital supporting that asset. For types of insurer that focus on accepting complex risks, the financial assets and the associated investment income, together with the surplus and reserves supporting the insured risks are likely to be attributed to the part of the enterprise which assumes and manages the insured risk.

105. One issue to determine is what actions are considered necessary for one part of an enterprise to be considered as accepting and managing the insured risk. Mere “rubber stamping” of a decision to accept the insured risk already taken in practice would not amount to performance of a key entrepreneurial risk taking function. However, more complex issues can arise. For example, where overall underwriting risk limits are set by Head Office and the PE is free to exercise its discretion within those limits as to which particular risks to accept. In such circumstances it will be important to determine which part, or parts, of the enterprise performs the underwriting function. The degree of decision making necessary to accept risk will depend very much on the nature of the insurance product. These issues are discussed further in Section D-2(v) a.

106. It is also necessary to identify whether other functions beside the underwriting function can be the key entrepreneurial risk taking functions and whether such functions accordingly require surplus to support their performance and the assumption of associated risk. For example, the asset management function has a prima facie link with market risk which might suggest that surplus should be attributed to the part of the enterprise which performs that function. The market place and regulators appear to require the maintenance of surplus in respect of the other types of risks. It follows that the assumption of those risks requires surplus. A more difficult question is which part of the enterprise assumes the risks. Is it reasonable that the risks and surplus be attributed to the operational functions that have created or generated the risks?

[Views from business are particularly invited on what types of risk require surplus and how to determine both the quantum of surplus required and the location of that surplus.]

107. The assets and risks recorded in the accounts and books of the PE form a practical starting point for determining whether the economic ownership of assets and risks have been assigned to the location where the key entrepreneurial risk-taking functions were performed. The accounts and books should be respected for tax purposes, provided they reflect an attribution of assets and risks that is consistent with the functional and factual analysis. There may, however, be cases where the accounts and records are inconsistent with the functional and factual analysis, for example, because material amounts of assets and risks may be booked in a location where none, or very few, of the key entrepreneurial risk taking functions related to their creation or subsequent management were performed. Respecting the booking location in such cases would not lead to an arm's length attribution of profit.

108. This is why the theoretical basis of the authorised OECD approach is that assets and risks are attributed by reference to a functional and factual analysis, especially the identification of the key entrepreneurial risk taking functions. Following the aggregation principle of the Guidelines (see paragraph 1.42) this analysis may be performed at the level of portfolios of similar assets and risks, rather than for each individual asset and risk.

b) Split Functions

109. Where the functional analysis has determined that the PE alone has performed the key entrepreneurial risk-taking functions, the PE will be attributed the newly created insured risks, together with the associated underwriting income and investment income from the assets required as surplus and reserves to support the insured risks. Tax issues will arise where all functions relevant to the acceptance of a particular insurance liability are not performed in the same location. For example, customer contact may be undertaken by the PE whilst the underwriting expertise may be in another part of the enterprise. Where the functional analysis shows that some of the functions leading to the PE assuming a liability were performed by other parts of the enterprise, those are "dealings" between the PE and the other part of the enterprise to be taken into account under the second step of the WH. However, as noted above it is the part of the enterprise performing the key risk taking entrepreneurial function that is treated as the "economic owner" of the financial assets, underwriting income etc associated with the performance of that function. In short, risks follow ownership and so the "economic ownership" is not split unless the key entrepreneurial risk-taking function is performed in more than one location.

110. Where the functional analysis shows that the key entrepreneurial risk-taking functions leading to the acceptance of the insured risks have been performed in more than one location that insured risk can be considered as economically owned jointly. The relative value of those functions performed in the different parts of the enterprise will be used to attribute the insured risk and the associated underwriting and investment income from financial assets. For example, if it were determined that 60% of the value of the

key entrepreneurial risk-taking functions were performed in the PE and 40% in head office, the insured risk and associated underwriting and investment income would similarly be attributed 60% to the PE and 40% to head office. The guidance in the Guidelines will be applied, by analogy, in order to determine the relative value of the key entrepreneurial risk-taking functions performed in the different parts of the enterprise. Again, following the aggregation principle of paragraph 1.42 of the Guidelines, the analysis may be made at the portfolio or book level of similar assets and risks, rather than for each individual financial asset or risk.

111.

c) Indirect Benefits Provided by Sales PEs

112. A particular situation found in insurance is that in some instances an insurer may operate in a country in a number of ways. It may have a permanent establishment as a result of a fixed place of business under Article 5(1) of the OECD Model Tax Convention, but it may also have agent(s) or subsidiaries carrying out business in that location. The question arises as to how such a structure will affect the profit to be attributed to the permanent establishment.

113. For example, look at the situation where the enterprise operates in country A through a permanent establishment and also through independent sales agents. A PE may only deal with a limited range of products, for example Life, and the independent agents may be selling other products which are run and managed by head office or other PEs. In this case it would not be appropriate to attribute the sales and marketing function and the risk underwriting function of contracts entered into by the independent agents to the permanent establishment, and to attribute relevant costs such as commission to the PE, as the permanent establishment is functionally not involved with the contracts sold by the independent agents. This demonstrates that there is no “force or attraction” element in the authorised OECD approach – we cannot say that just because an enterprise has a permanent establishment in a country, it will have the risks and rewards of all activity carried out there.

114. However, it will also be important to further examine whether the permanent establishment is in practice performing some services which need to be rewarded. The permanent establishment may have engaged in a major advertising campaign designed to raise the profile of the insurer and its brand name. This may well be enhancing the sales by the agents, and the profits of these sales can be attributed to the head office. It would then be a matter of applying the Guidelines to the particular situation. The Guidelines would determine whether any benefits to head office was purely incidental to the benefit to the PE, whether the PE would be treated as providing a service of promoting the insurer’s brand name and product image, or whether the PE would be treated as the “economic owner” of a new or developed intangible.

115. The same general approach is needed where the PE may be directly or indirectly benefiting a subsidiary of the entity operating in the same country. It is a general transfer pricing issue as to whether charges should be imposed in respect of services rendered in either direction and the guidance in Chapter VII and VIII of the Guidelines should be followed by analogy for insurance PEs.

d) Agency PEs

116. As indicated in Section C-2 (v) in Part I, this Report does not examine the issue of whether a PE exists under Article 5(5) of the Model Tax Convention (a “dependent agent PE”)⁴ but discusses the

⁴ Some tax conventions between OECD Members contain a special provision that deems an insurance company to have a PE when the company insures a risk situated in that country through an agent of

consequences of finding that a dependent agent PE exists in terms of the profits that should be attributed to the dependent agent PE. It is worth emphasising at the outset that the discussion below is not predicated on any lowering of the threshold of what constitutes a PE under Article 5. However, it is a fact that some of the functions associated with an insurance business are commonly undertaken by dependent agents within the meaning of Article 5(5). For example, an insurance company may employ one or more dedicated brokers (“dependent agent enterprise”) to market their policies within the host jurisdiction and may give that broker authority to bind the insurance company with respect to those policies. General guidance on the attribution of profits to dependent agent PEs is contained in Section C-2 (iv) of Part I and this section applies that guidance to the specific factual situation of cross-border insurance.

117. In cases where a PE arises from the activities of a dependent agent, the host jurisdiction will have taxing rights over two different legal entities - the dependent agent enterprise (which is a resident of the PE jurisdiction) and the dependent agent PE (which is a PE of a non-resident enterprise). In respect of transactions between the associated enterprises (the dependent agent enterprise and the non-resident enterprise), Article 9 will be the relevant article in determining whether the transactions between the associated enterprises were conducted on an arm’s length basis.

118. In respect of the dependent agent PE, the issue to be addressed is one of determining the profits of the non-resident enterprise which are attributable to its dependent agent PE in the host country (i.e. as a result of activities carried out by the dependent agent enterprise on the non resident enterprise’s behalf). In this situation, Article 7 will be the relevant article. Finally, it is worth stressing that the host country can only tax the profits of the non-resident insurance company where the functions in the host country performed on behalf of the non-resident enterprise exceed the PE threshold as defined under Article 5. Further, the quantum of that profit is limited to the business profits attributable to the insurance functions performed through the PE in the host country.

119. Where a dependent agent PE is found to exist under Article 5(5), the question arises as to how to attribute profits to the PE. The answer is to follow the same principles as used for other types of PEs for to do otherwise would be inconsistent with Article 7 and the arm’s length principle. Under the first step of the authorised OECD approach a factual and functional analysis determines the functions undertaken by the dependent agent enterprise both on its own account and on behalf of the non-resident enterprise. On the one hand, the dependent agent enterprise will be rewarded for the services it provides to the non-resident enterprise (taking into account its assets and its risks) usually by means of a [brokerage] fee from the non-resident enterprise.

120. On the other hand, the dependent agent PE will have attributed to it the liabilities, assets and risks of the non-resident enterprise relating to the functions performed on its behalf by the dependent agent enterprise, together with sufficient surplus to support those liabilities, assets and risks. The authorised OECD approach then attributes profits to the dependent agent PE on the basis of those liabilities, assets, risks and surplus. The analysis focuses on the nature of the functions carried out by the dependent agent on behalf of the non-resident enterprise and in particular whether it undertakes key entrepreneurial risk-taking functions. In this regard an analysis of the skills and expertise of the employees of the dependent agent enterprise is likely to be instructive, for example in determining whether underwriting or negotiating functions are being performed by the dependent agent on behalf of the non resident enterprise. The collection of premiums does not mean that the dependent agent PE is accepting the insured risk, if the decision to accept the risks associated with the insurance policy is not made by the dependent agent.

independent status. See Comment 39 on Article 5 of OECD Model Convention. The principles discussed in this Report would apply to attribute profits to these types of PE.

121. In calculating the profits attributable to the dependent agent PE, it would be necessary to deduct an arm's length reward to the dependent agent enterprise for the services it provides to the non-resident enterprise (taking into account its assets and its risks). Issues arise as to whether there would remain any profits to be attributed to the dependent agent PE after an arm's length reward has been given to the dependent agent enterprise. In accordance with the principles outlined above, the answer is that it depends on the precise facts and circumstances as revealed by the factual and functional analysis. The reward should provide the appropriate remuneration for the functions performed (taking into account the assets used and risks assumed) by the dependent agent enterprise in its own right.

122. However, a functional and factual analysis of a transaction may show that the risks arising from the transaction are being assumed by the dependent agent enterprise for the account of its principal, i.e. the non-resident enterprise in whose books the transaction - and the resultant risk - appears. These risks, and therefore the surplus needed to support them, will be attributed to the dependent agent PE to the extent that they arise from functions performed by the dependent agent in the host country on behalf of the non-resident enterprise. In short, when attributing profits (both underwriting and investment income) to the dependent agent PE, there are likely to be profits (or losses) over and above the arm's length service fee paid to the dependent agent enterprise. This is particularly true in the case of insurance as the initial assumption and subsequent bearing of risk, and the corresponding need to maintain surplus to provide a cushion against the realisation of losses from those risks, is fundamental to the business.

123. In addition to selling insurance through a dependent agent, a company may also sell insurance through agents of "independent status", the activities of which generally will not constitute a PE. Thus, an insurance company may have PEs resulting from the activities of some agents (dependent agents) but not other agents (independent agents) selling insurance in the same country. In these cases, independent agents may derive substantial benefits from a PE (arising either from a fixed place of business or from a dependent agent) located in the same jurisdiction. For example, independent agents may only be able to sell insurance of a company because a PE has obtained a license to sell insurance in that jurisdiction. The PE may also be engaging in activities that indirectly support insurance sales made by the independent agents such as marketing activities and ensuring that the company's policies comply with tax and regulatory requirements. Accordingly, the functional analysis must consider the functions performed, assets used, and risks assumed through the fixed place of business or dependent agents that benefit the business conducted through independent agents. See discussion in Section D.1 (i) (c) above.

124. The PE should receive appropriate compensation for performing these functions, either directly from the independent agent (adjusted, if necessary, to an arm's length reward where the independent agent is an associated enterprise) or indirectly, from the part of the enterprise that benefits from the activities of the independent agents. In the latter case, the compensation should be determined under the same principles that are discussed below in the second step of the WH described in Section D-2.

ii) *Attributing creditworthiness /solvency margin to the PE*

125. For similar reasons as stated for banks in Part II of this Report, the starting point of the authorised OECD approach is generally to attribute the same creditworthiness or solvency margin to the PE as enjoyed by the insurance enterprise as a whole. Third parties doing business with the PE would assume that all the assets of the enterprise would be available to support its insurance liabilities. However, in the insurance industry there may be cases where because of regulatory or other restrictions (see discussion on "trusteed" assets at paragraphs 58-59) this is often not the case in a particular jurisdiction and so the creditworthiness or solvency margin of the PE may need to be determined on a "stand-alone" basis taking into account the regulatory and other restrictions in that jurisdiction. In such cases, it will be necessary to determine the creditworthiness of the PE, for example by reference to independent enterprises in the host

country that are comparable in terms of assets, risks, management etc. or by reference to objective benchmarks such as evaluations of creditworthiness from independent parties that evaluate the PE based on its facts and circumstances and without reference to the enterprise of which it is a part.

iii) Attributing Investment Income/Assets and Surplus to the PE

126. Section B-2 (i) described the importance of investment income for an insurance company. That investment income arises largely due to the investment of the surplus and reserves that the regulators require the insurer to have in order to undertake insurance business. In order to arrive at an arm's length attribution of taxable profits to an insurance PE, it is therefore vital to ensure an appropriate attribution of surplus to the PE. This section considers how to determine the arm's length amount of surplus that should be attributed to the PE.

a) General overview

127. As described in Section B-2(i), the assumption of the insured risk leads to the acceptance of underwriting risk, i.e. the potential for actual claims and expenses to exceed expected claims and expenses. This underwriting risk (along with the other types of risk described in section B-4 (i) can only be assumed if there is surplus available to provide a cushion in the event that reserves are insufficient to meet claims.

128. The question arises as to what is the effect of attributing surplus to a PE. As described in section B-1(i), in the insurance business, the acceptance of insured risk results in the creation of liabilities in the form of reserves representing the future claims of the insured. Assets used to back those liabilities (in the form of reserves) obtain a return (referred to as investment income) which may help to pay the future claims. Assets representing the surplus also obtain an investment return, which may be used to pay out claims, in the case where underwriting or investment risk have been realised and reserves are insufficient, or to increase surplus through an increase in profit.. Thus, the investment return from the surplus is part of the 'investment income' attributable to an insurance business, and therefore, an essential component in determining the taxable income of the business.

129. How then can the authorised OECD approach be applied to insurance business and the investment return derived from it? The authorised OECD approach requires that a PE of an insurance company be hypothesised as a distinct and separate enterprise from the enterprise of which it is a part. There must then be attributed to the PE the surplus that it would have if it were a distinct and separate enterprise carrying on the same activities and incurring the same risks.

130. In considering how the authorised OECD approach may apply to determine what surplus and therefore what investment income and gains are attributable to a PE, it must be appreciated that a company will not be able to carry on business if it holds merely the minimum amount of surplus required by regulators. Those placing business with insurers are heavily influenced by a company's financial strength – particularly in life and other long term business where the policyholder needs assurance not only that the company is in a position to meet its liabilities at the time the policy is taken out but that it is likely still to be in business and still able to pay out in many years or decades time.

131. This means that to attribute to a PE only the minimum regulatory surplus may not produce arm's length results.

132. The example below shows the importance of attributing the correct amount of surplus to a PE.

Example (please note the figures are for illustration only)

133. Assume that Goodluck Insurance Company, which is a resident of Country B, carries on exactly the same activities and undertakes exactly the same type and amounts of insured risk in Country A as in Country B. The activities in Country A consist of accepting an insurance premium of \$100 from a third party, taking a reserve deduction on the first day of the year and investing that reserve in Country A that produces at 10% a return of \$10. On the last day of the year the business in Country A pays a claim to the third party of \$108.

Situation 1: Goodluck Insurance operates through a PE in Country A

134. Country B’s regulators apply a standard that requires that the entire business of Goodluck Insurance have minimal capital adequacy (or a minimum amount of surplus). Accordingly, the regulators in Country A do not insist on the PE of Goodluck Insurance in Country A maintaining any separate minimum regulatory capital. If the determination of income attributable to Goodluck’s PE in Country A follows the regulatory treatment, then Goodluck Insurance PE has no surplus allotted to it and so its operations are wholly funded by the premiums paid producing the following gross profit margin:

Earned Premiums		=	100
Plus: Investment Income	=	100*.10	= 10
Less: Claims Incurred		=	108
Gross Profit Margin		=	2

Situation 2: Goodluck Insurance

135. Assume in this situation that Goodluck Insurance’s PE is regulated by Country A’s regulators who instead follow the minimum capital adequacy standards and ensure that Goodluck’s PE fulfils minimum capital adequacy requirements based on its global activities. Accordingly, the regulators in Country A insist that Goodluck Ltd maintains a minimum surplus ratio of 20% in Country A 136. It is necessary to calculate the amount of the surplus which has enabled Goodluck Insurance to take on underwriting and other forms of risk in Country A, and the return to that surplus in the form of investment income should be attributed to Goodluck’s PE. If this standard is applied, the insurance PE will receive investment income on \$120 as follows:

Earned Premiums		=	100
Plus: Investment Income	=	120*.10	= 12
Less: Claims Incurred		=	108
Gross Profit Margin		=	4

137. The gross profit margin of the PE is twice as large as above simply because of regulatory differences permitting it to operate without surplus in the first example.

Situation 3: Goodluck Insurance operates through PE in Country A and the authorised OECD approach is applied

138. Finally, let us assume that we are again in Situation 1, but in fact, the surplus of the business as a whole is 30% and that the tax authorities in Country A say that according to the authorised OECD approach there must be attributed to the PE the surplus which it would have if it were a distinct and separate enterprise carrying on the same activities and incurring the same risks. Further, the authorities in Country A apply an approach similar to the capital allocation approach for attributing capital to bank PEs (see Part II of this Report for further details). The facts of the case state that the same kinds of business are performed (and the same kinds and amounts of insured risk incurred) in Country A as in the rest of the

Goodluck Insurance business, then the surplus should be allocated proportionately to the PE of the business, and it would thus have a 30% surplus, even though the regulatory minimum remains 20%. This would result in the following calculation of gross profit margin for the PE:

Earned Premiums		=	100
Plus: Investment Income	=	130*.10	= 13
Less: Claims Incurred		=	108
Gross Profit Margin		=	5

139. In this particular case, application of the capital allocation approach of the authorised OECD approach yields a larger gross profit margin than under the minimum capital adequacy standards, because the actual surplus of the business as a whole is larger than that required by the capital adequacy standards requirement. It should be noted that other outcomes are also possible if the facts in the example are changed, and this example involved situations where the activities of the PE and the Head Office were identical such that the logical allocation of the surplus should be proportionate. In reality, the operations of the Heads Office and the PE will vary to a lesser or greater extent (for example, by lines of business, particular functions undertaken by a PE, etc). In these more complicated factual situations, these and other factors will need to be used to determine the appropriate attribution of surplus to a PE.

140. The example above illustrates the need to decide on the authorised OECD approaches to attributing surplus. Two authorised approaches were chosen in Parts I- III; (1) capital allocation, and (2) thin capitalisation, although a third approach - quasi-thin capitalisation - can be applied albeit only as a safe harbour. The rest of this section examines the strengths and weaknesses of the three authorised approaches to attribute surplus to an insurance PE.

b) Capital allocation approach

141. There are two principles that underlie the allocation of surplus to the PE under the capital allocation approach. First, that the surplus of a business supports all of its business, whatever the nature of the business, and without regard to where such business is conducted (see paragraph 149 below for discussion of an exception to this rule). Second, that all of the surplus of the entire business must be attributed to the various parts of the business, and accordingly, the sum of the attributable surplus will be neither more nor less than the total surplus belonging to the business as a whole. The amount of surplus to be allocated under the authorised OECD approach is the actual amount of surplus of the insurance enterprise. The surplus supports the insurance risks assumed by the enterprise as a whole and allocation should be made in proportion to the insurance risks assumed by each part of the enterprise. However, the above principles do not always apply to all insurance enterprises. As noted in paragraphs 60-61, in some jurisdictions the host country regulatory rules will mean that assets (“trusteed assets”) are only available to meet claims in the host country jurisdiction and so the capital of the insurance enterprise is in fact segregated to some extent.

142. It will be necessary to properly allocate the total surplus of the enterprise and not just the regulatory minimum, if capital allocation approaches are to be used as a proxy for the application of the arm’s length principle. This is on the basis that all the assets and all the associated risks have been attributed to the various parts of the enterprise, including the head office, under the functional analysis. Given a functionally based attribution of assets and, especially, risks, there is no reason to attribute part of the surplus to head office simply on the basis that the head office would be expected to absorb any extraordinary and unforeseeable losses arising from the realisation of risks. Instead, this determination would be based on the functional analysis.

143. However, Article 7(2) requires that the PE be regarded as a distinct and separate enterprise from the enterprise of which it forms part. It might therefore be argued that, as a distinct and separate enterprise, the PE and the rest of the enterprise would require more surplus to support activities than is actually the case in operating as one larger enterprise. The reason would be that an insurance enterprise pools the risks incurred in each of its parts and thus, in terms of requirement of surplus to meet claims, it benefits from spreading such risk across a wider range of potential claims.

144. However, Article 7(2) also requires that the PE be hypothesised, as a distinct and separate enterprise from the enterprise of which it forms part, but performing the same or similar functions under the same or similar conditions. The advantage of pooling should thus be attributed to each of the hypothesised distinct and separate enterprises (i.e. the PE and the rest of the enterprise), so that the surplus requirements of each are reduced to those of the actual overall legal enterprise. The concept might best be understood if the two hypothesised distinct and separate enterprises are treated as having entered a risk pooling agreement which reduces their total need for surplus. Where such agreements exist between actual separate legal enterprise, neither party has a claim to the reduction in surplus and this result should be reflected when applying the Guidelines by analogy. That is, the surplus to be allocated to the different parts of the overall legal entity is the actual surplus held by the entity and not a hypothetical amount.

145. In the Goodluck example above, the third situation yields the desired outcome under the capital allocation approach. However, that situation is deliberately simplified in that the PE is carrying on exactly the same type of business and assuming the same kind of risks as the enterprise as a whole so that it is possible to apply the surplus ratio of the enterprise to the PE. This raises the issue of what should be done where there are significant differences in functions and, especially, the risks assumed between the PE and the enterprise of which it is a part. This issue is not confined to insurance and is discussed in both Parts I and II. As discussed for banks in Part II, one possible approach might be to use risk based regulatory standards as a proxy for the desired outcome to the extent that the standard is based on similar principles to the authorised OECD approach. It should be made clear that the regulatory standard would only be used as a proxy, and if the factual and functional analysis indicated that a different outcome more accurately represented the arm's length principle, that outcome would be applied.

146. This raises an important question of whether there are internationally accepted risk based regulatory standards that could be adapted so as to approximate an arm's length attribution of capital to parts of an insurance business in most situations. All OECD member countries regulate insurance business and set minimum asset and surplus requirements for insurance companies regulated in their jurisdiction. However, in insurance there is not an internationally accepted standard as exists in banking where the Basel Accord plays an important part in setting global standards. Each jurisdiction sets its own standards, though in the European Economic Area there is a single approach set out in the Insurance Directives. However, even in those states where the regulator requires a minimum amount of surplus to be allocated to a PE, this amount may not approximate to an arm's length allocation. Also it may be that assets are required to be held by the PE for regulatory reasons even though the PE has not undertaken any of the functions leading to the assumption and management of insured risk and so would not be attributed those assets under the authorised OECD approach.

147. In applying the capital allocation approach, it is necessary to consider the treatment of trustee assets, as described in Section B-3. To the extent that such assets may not be used to support activities outside the jurisdiction in which the trusts are located, the factual premise underlying the capital allocation approach would be violated. To the extent that a PE is required to maintain trustee assets (both reserves and surplus) in a country to support a PE's business, investment income from those assets will be attributable to the PE. Other trustee assets, in excess of the amount necessary to support the PE's business activity, may be attributable to the PE if properly allocable to the PE under a capital allocation approach. However, investment income from trustee investment assets that are not part of the PE are not

attributable to the PE. Investment income from trustee assets that are not part of the PE may be subject to income taxation by the home office.

148. Accordingly, it would seem appropriate to allocate an amount of capital (also referred to as surplus) at least equal to the amount of minimum surplus that must be maintained as trustee assets in the jurisdiction in which the trust is located. In that case, it would be inappropriate to take those assets, and the investment income related to them, into account when determining the amount of capital and the investment yield to be attributed to other jurisdictions. However, in many cases this will not be a problem in practice, as the amount of minimum surplus held as trustee assets and investment income earned on that surplus may be less than the amount of surplus and investment income that would have been allocated to that jurisdiction if the entire surplus of the insurance company were taken into account. Accordingly, it might still be necessary to attribute more capital (surplus) to the permanent establishment than is represented by the trustee assets. In this respect, the minimum surplus held as trustee assets are treated similarly to minimum regulatory capital in the banking context.

149. As discussed in Part II (paragraph 91), allocating capital under the “standardised” approaches of risk-weighting assets under the Basle Accord is felt to be a reasonable approximation of an arm’s length result based on the relative risk-weighted assets properly attributed to each part of the banking enterprise. In the insurance industry, the absence of an internationally accepted regulatory standard makes it much more difficult to come up with a method that is both a reasonable approximation to an arm’s length result and retains the main advantage of the standardised regulatory based approach, i.e. that the capital allocated to each part of the enterprise when added up should be neither more nor less than the actual capital of the enterprise. However, as acknowledged in Part II, there are weaknesses in the standardised regulatory approaches and so, recognising the need for flexibility, other approaches to measuring risk and allocating capital in accordance with the arm’s length principle are permitted for banks, e.g. using the bank’s own risk measurement models subject to certain caveats (see paragraph 92). Again as noted in Parts I-III, it may be that other authorised OECD capital attribution approaches could be applied more reliably in such circumstances. The rest of this sub-section examines a number of possible allocation keys that could be used to allocate the surplus to a PE in a manner that approximates to an arm’s length result for an enterprise conducting insurance business.

1. Premiums

150. Historically, a number of countries have used premiums as an allocation key when applying the formulary approach of Article 7(4) and therefore it should at least be considered whether it would be possible to use premiums as a key to the allocation of surplus in a manner consistent with the arms’ length principle. Clearly, there are a number of situations where this would lead to an inappropriate result, especially where the premium key was applied to allocate surplus supporting different types of business where there was not a similar relationship between the level of premium and surplus. For example, insurance for extremely unlikely but potentially catastrophic events like earthquakes might carry the same premium as motor insurance but would require vastly more in the way of surplus. However, there may be scope for using premiums for lines of similar business where there is likely to be a direct relationship between the amount of premium and surplus, for example, the sale of standardised insurance products marketed in only a few countries.

2. Technical reserves

151. Another potential key for allocating surplus could be to use the relative level of technical reserves in each part of the enterprise. However, this raises a number of problems. Countries differ quite a lot in their regulatory requirements for making reserves and some countries are more stringent on requiring reserves than others (e.g. whether or not they require catastrophe or equalisation reserves), whilst other

countries do not require technical reserves at all. Further, there is a particular problem in using technical reserves in the case of variable annuities (linked life assurance) which carry little technical risk but very high reserves.

152. If technical reserves are to be used, questions also arise as whether home or host country regulations should be used. This raises compliance issues as to whether regulatory information would be available, for example if it was decided to apply home country rules on technical reserves to each host country where the PE would have surplus to be allocated. Another problem is that there may well be a trade-off in terms of a host country's regulatory policy for requiring reserves and surplus. For example, if stringent technical reserves are required then there is less need for surplus and vice versa. Consequently, surplus would be over-allocated to countries under the host country approach where the regulatory regime focuses on reserves rather than on surplus.

3. Other regulatory and hybrid approaches

153. There are other regulatory measures, such as solvency margins, minimum regulatory asset requirements etc which could potentially be used as keys to allocate the surplus. Moreover, any of the quasi-thin capitalisation or thin capitalisation approaches described in the sub-sections below could also potentially be used not in their own right but as keys to allocate the actual surplus (hybrid approaches). For example, the actual surplus of the enterprise could be allocated according to the relative regulatory minimum surplus requirement in each part of the enterprise. These approaches are discussed in more detail in the sub-section below discussing quasi thin capitalisation approaches.

[Views from business are invited on the desirability and feasibility of the hybrid approaches referred to above]

4. Provisional conclusion for capital allocation

154. More thought needs to be given to methods of allocating the surplus so as to approximate to an arm's length result. It is however clear that it is unlikely that a single allocation key could be found to allocate the surplus of a diversified insurance enterprise. It would therefore be interesting to know what data would be available to split the capital of an insurance business into the various business lines so that allocations could be made between locations within each business area using different allocation keys. It is hoped that the insurance industry will be able to assist greatly on this important matter.

155. Moreover, it should be borne in mind that the authorised OECD approach attributes risk and surplus in accordance with the arm's length principle, rather than following regulatory approaches for measuring risks or determining surplus or assets. Regulatory developments will need to be carefully monitored to ensure that any changes do not affect the reliability of any regulatory approach as a proxy for measuring the risks attributable to a bank PE under the arm's length principle.

[Views from business are particularly welcome on the strengths and weaknesses of the possible approaches discussed in this section.]

c) Thin capitalisation approach

156. Another authorised OECD approach is the thin capitalisation approach. This would attribute surplus to an insurance PE by reference to the capital structure and debt/equity ratio of an independent insurance enterprise carrying on the same or similar activities, using the same or similar assets and assuming the same or similar risks under the same or similar conditions. The strengths and weaknesses of

this approach are discussed in Part I (Section C-2(iv) and Part II (section D-1(iii)). Similar issues are likely to arise for insurance companies.

d) Safe harbour - Quasi-thin capitalisation/regulatory minimum approach

157. Another possibility would be to require the PE to have at least the same minimum amount of surplus required for regulatory purposes (regulatory minimum surplus) as would an independent enterprise conducting insurance business in the host country (*a quasi-thin capitalisation approach*). The regulatory minimum surplus would be determined in accordance with the regulatory standards and tax characterisation rules of the host country. Insurance regulatory standards will attempt to measure the minimum amount of surplus that an insurance company must possess before it is given regulatory permission to carry on business in a particular jurisdiction. Therefore, it is useful to see what these standards do and how they do it to see if they could be used to attribute surplus, either directly as a safe harbour quasi-thin capitalisation approach or indirectly as an allocation key under the capital allocation approach described above. Generally, the standards differ in the way the minimum surplus amount is calculated, but the amount required will bear a close relationship to the nature of the risks undertaken and will be calculated by reference to premiums, claims and types of business.

158. The extent to which differing types of risk assumed by the enterprise affect the minimum surplus required varies from jurisdiction to jurisdiction. This may be because in some cases, particularly in life insurance, matters such as risks inherent in the assets used to back the business may be taken into account in determining the level of provisions for policyholder liabilities. The more such risks are taken into account in that area, the less they need to be taken into account in determining the surplus needed. For example, a regulator may require a company to calculate its provisions by assuming only a risk free rate of return such as can be obtained on Government securities, even though the company holds equity investments likely to produce a greater return.

159. It may be possible to determine for any given PE what the minimum assets required for that PE by the host state regulator will be (although there are problems in the European Union due to the liberalisation of host country regulation). The regulators will generally be concerned with “admitted assets”, or those assets that are sufficiently liquid so that they can be used to pay claims. Either the regulator will actually require the PE to demonstrate that amount of admitted assets is available in the jurisdiction, for example, by being retained in a trust, or the regulator’s criteria can be applied to the PE. However, this may not be the arm’s length amount of surplus that should be attributed to the PE. Moreover, this approach does not provide information about which of the assets that constitute surplus are subject to taxation, which income and gains will be taxed or what rate of return should be obtained on those assets (see sub-section e below).

160. Further, the regulatory accounts in the home state may specifically show certain assets as attributable to the PE, even though the PE accounts do not show them. Such assets may nevertheless need to be attributed to the PE under the authorised OECD approach.

161. Accounts of the PE may also show more assets than the bare minimum surplus requirement of the host state regulator. Indeed, if the PE holds assets in excess of the minimum surplus required it would be expected that any accounts would show this as well as the income and gains arising from them and such assets may also be attributed to the PE under the authorised OECD approach . But the PE’s accounts may not be drawn up on a basis that reflects the distinct and separate enterprise approach. It is necessary to start from the authorised OECD approach to establish what assets and what income and gains flowing from them should be attributed to the PE. Similar to the situation described for banks, an arm’s length attribution

of surplus and assets may have to be made to an insurance PE, even though no such surplus or assets have been formally attributed to the PE for regulatory or other purposes.

162. The focus of the “quasi-thin capitalisation/regulatory minimum capital” approach is on providing an administratively simple way of ensuring that the PE cannot have less surplus than the regulatory minimum surplus for an independent enterprise conducting insurance business in the same jurisdiction. This approach is not an authorised capital attribution approach as it ignores important internal conditions of the authorised OECD approach, e.g. that the PE generally has the same creditworthiness as the enterprise as a whole. However, it may be acceptable as a safe harbour as long as it does not result in the attribution of more profits to the PE than would be attributed by an authorised OECD approach⁵.

163. Where the approach is applied as a safe harbour (for example, the PE would be required to have a certain minimum surplus ratio (say 20% as in the earlier Goodluck example), the taxpayer is given the opportunity to demonstrate that the PE actually requires less surplus than the safe harbour surplus ratio. Such a demonstration would have to be based on the principles set out in this section.

164. There are other situations where there may be problems with this approach. The effect of attributing only the regulatory minimum surplus for each of the countries where the enterprise has PEs is that any surplus in excess of that amount is effectively allocated to the head office. However, the effect of such an approach is that the host country is exercising less than its potential taxing rights under Article 7 and so there are unlikely to be problems of double taxation. Problems of less than single taxation would arise if the home country were to relieve double taxation by reference to the full arm’s length amount of profit even though the host country has taxed less than that amount, as frequently occurs in the case of certain exemption systems.⁶

[Views from business are invited on the desirability and feasibility of applying the quasi-thin capitalisation approach, including whether it could be applied other than only as a safe harbour]

e) Conclusion on attributing surplus to the PE

165. The attribution of surplus among parts of an enterprise involved in insurance business is a pivotal step in the process of attributing profit to its PE. In particular, taken together with reserves, it largely determines the amount of investment income that the PE should be considered to have. For insurance enterprises, surplus fulfils a similar role as capital for other enterprises. So an insurance PE, just like any other type of PE, should have sufficient surplus to support the functions it undertakes, the assets it uses and, crucially, the insurance risks it assumes. For this reason, the method by which surplus is attributed is an important step in avoiding or minimising double taxation.

166. The consultation process on Parts I-III has shown that there is an international consensus amongst governments and business on the principle that a PE should have sufficient capital to support the functions it undertakes, the assets it uses and, the risks it assumes. However, it is not possible to develop a single internationally accepted approach for making that attribution of capital, including “free” capital. As can be seen from the discussions above, there is no single approach which is capable of dealing with all the circumstances of an insurance business and so the same conclusion is reached for the attribution of surplus to an insurance PE.

⁵ As explained in paragraph 111, in many cases the effect of a regulatory minimum capital approach would be that the host country taxes less than it would using a capital allocation or thin capitalisation approach.

⁶ See Part I Section C-2 (v) (c) for a general discussion of safe harbour approaches to the attribution of capital.

167. Rather, the focus of the OECD work is on articulating the principles under which such an attribution of surplus should be made and on providing guidance on applying those principles in practice and in a flexible and pragmatic manner. As such, whilst any of the authorised OECD approaches described in this section are capable of producing an arm's length result, there may be particular situations where the approach does not produce an arm's length result and so flexibility may be required but in a manner that minimises the incidence of double taxation.

168. The fact that countries may incorporate different authorised approaches in their domestic regimes has raised concerns that double taxation may arise. However, Article 23 requires home countries to accept host country domestic rules consistent with one or more of the authorised approaches, provided the result is consistent with the arm's length principle in a particular case. It follows that in such circumstances the home country should give relief for tax on profits calculated under the host country basis. This is the case even where the home country has a domestic rule which attributes surplus in accordance with another of the approved approaches. The symmetrical application of the authorised OECD approach is discussed in more detail in Section B-2 of Part I.

169. Nevertheless, there will inevitably be some cases where tax administrations disagree over whether the results produced by the host country method are consistent with the arm's length principle. The Mutual Agreement Procedure is available to resolve such differences. The fact that it will sometimes be necessary to resolve disputes through MAP is not a weakness of the authorised OECD approach. Rather it reflects the fact that the attribution of surplus to a PE can be a very difficult and complex issue. The authorised OECD approach describes the strengths and weakness of different approaches and therefore provides a framework for resolving difficult cases.

f) Determining the investment yield from surplus attributed to a PE

170. The determination of the amount of surplus to be attributed to the PE is not the end of the matter. The next question is what investment yield should be attributed to the assets. The answer will depend to a certain extent on the method chosen to determine the amount of the surplus. In particular, if a capital allocation approach has been used then it would not be possible to directly identify all the assets supporting the insurance risk and so some means of identification would have to be developed.

171. The determination of the type of assets to be attributed to the PE will depend upon the facts and circumstances of each company, but in addition to the accounts of the PE, there are a number of factors that may provide guidance in this regard. Different types of insurance business call for different types of asset. Some types of life insurance business for example may be backed heavily by equities, while, where annuities are in payment, most insurance companies would seek to support these obligations with Government and other less risky debt securities with an investment return profile that matched the expected annuity payment.

172. Another factor may be the currency in which assets are denominated. Insurance regulations generally insist on more or less complete matching of the currency of assets and liabilities, to prevent excessive foreign exchange exposure. Accordingly, the allocation of assets must consider the denomination of assets, including any related hedging of currency risks, to ensure both that the appropriate assets are attributed to the PE and that an arm's length rate of return is determined for those assets.

173. In the case of a jurisdiction that has required the non-resident enterprise to place particular assets in trust, it may be appropriate to attribute the investment income earned with respect to those assets to the jurisdiction in which the trust is located, to the extent that key entrepreneurial risk taking functions are performed by a PE in that location. However, it would still be necessary to determine an investment yield

with respect to investment of any surplus that is attributed to that jurisdiction above and beyond what is represented by the trustee assets.

174. It may be the case that the head office is explicitly “managing” the investment of assets for its PEs, on the basis that it is able to do so more effectively than the PE, through economies of scale, expertise etc. Such an arrangement raises issues of compensation for the investment management function under the second step of the authorised OECD approach.

175. Life insurers maintain separate accounts assets that are identified with specific clients and are generally more like investment holdings for which the insurer acts as investment manager for the clients. When determining the surplus to be allocated within the multinational enterprise the separate account assets should be taken into consideration to the extent that they are available to the insurer to pay claims or support risk.

[Views from business are invited on how to compensate the investment management function and on how to determine the yield from the investment of the surplus and reserves attributed to the PE.]

D-2. Second Step: Determining the Profits of the Hypothetical Distinct and Separate Enterprise(Based on a Comparability Analysis)

i) Identifying Dealings

176. As noted in Section D-1 of this report, the functional and factual analysis of the first step of the authorised OECD will have appropriately hypothesised the PE and the rest of the insurance enterprise as associated enterprises, each undertaking functions, using assets and assuming risks. Financial assets, such as those arising from the investment of reserves will also have been attributed to the part of the enterprise which performs the key entrepreneurial risk-taking functions leading to the creation of those assets. As noted above, other important characteristics (e.g. “an appropriate amount” of assets reflecting the technical reserves and surplus held to support insured risk carried) will also have been hypothesised to the PE and the rest of the enterprise.

177. The second step of the authorised OECD approach goes on to apply, by analogy, the guidance in the Guidelines to any economic relationships (“dealings”) between the hypothesised distinct and separate enterprises, i.e. the PE and the rest of the insurance enterprise. For example, although insured risks and the assets backing those insured risks may have been attributed to the PE in country A by virtue of the fact that the PE undertook the key entrepreneurial risk-taking functions leading to the acceptance and subsequent management of those insured risks, it may be that other parts of the enterprise performed other functions, such as investment management services in relation to those assets, or provided valuable intangibles etc. These functions or intangibles would need to be rewarded in order to ensure that the PE in country A is attributed an arm’s length profit, using any of the methods authorised by the Guidelines. The authorised OECD approach would be to record all the income associated with those risks and supporting assets in the books of the PE in Country A as the “economic owner” of the portfolio of risks and supporting assets and to attribute to it expenses in respect of the dealings representing an arm’s length reward for the functions performed by other parts of the enterprise. In particular, the concept of comparability analysis will be used in order to attribute profit in respect of these “dealings” by making a comparison with transactions undertaken between independent enterprises. It should also be noted that there is no presumption that these other dealings are by nature of low value. This will be determined by the functional and comparability analyses based on the particular facts and circumstances. A whole spectrum of results can be expected ranging from at one end routine low value dealings to at the other end dealings that result in a share of the residual profit of the economic owner.

178. General guidance on making such comparisons has been provided in Section C – 3 (iv) of Part I of this Report. This section discusses how to apply that guidance to issues specific to a PE conducting an insurance business.

ii) *Recognition of dealings*

179. As noted in paragraph 174 of Part I, there is a need for greater scrutiny of dealings between a PE and the rest of the enterprise of which it is a part than of transactions between two associated enterprises and so the onus is placed on the taxpayer to be able to demonstrate clearly that it would be appropriate to recognise the dealings. In short, it will be necessary first to determine whether any dealing exists in relation to the PE before deciding whether the dealing, as found, should be used as the basis for the analysis used to determine an arm's length attribution of profit.

180. It was seen in Parts II and III of this Report that problems may arise when trying to apply the guidance in Part I to dealings in relation to financial assets and risks, given the nature of financial businesses. Similar problems arise in relation to insurance. An insurance business consists of accepting and managing risks of losses arising from the realisation of events outside the control of the insured. Insurance businesses are able to accept and manage the risks of losses by pooling those risks among many risk averse persons via the payment of a premium by the insured to the insurer. To be able to accept the insured risk, and assume the associated risks, the insurer holds financial assets, which give rise to investment income. It can be difficult to determine where in the enterprise the insured risk, and risks assumed, are managed and where the financial assets are located and, in particular, whether the risk management functions or financial assets have been transferred to another part of the enterprise or whether another part of the enterprise has begun to use them.

181. The authorised OECD approach relies on the functional analysis to determine where insured risks are accepted and associated risks subsequently managed and where assets are used. The situation is made complex by the fact that the functions associated with insured risk acceptance and management, financial asset management and risk management can be disaggregated and performed by more than one part of the enterprise. Therefore an accounting entry, removing the risk or supporting assets from the books of one part of the enterprise and transferring them to the books of another part of the enterprise, would not of itself amount to a dealing. A dealing may arise if the purported transfer of risk is accompanied by a transfer of related functions, but the exact nature of the dealing might be difficult to determine. For example, would the dealing be the provision of risk management services rather than a transfer of the risk. This is particularly important in the insurance industry in respect of internal "reinsurance", which is discussed below. Where the transfer of the financial asset or risk is not recognised under the above criteria, there may nevertheless be other dealings to be taken into account, for example, where another part of the enterprise provides investment advice to the part of the enterprise treated as the "economic owner" of the asset.

182. Once the threshold has been passed and a dealing is recognised as existing, the authorised OECD approach applies, by analogy, the guidance at 1.36 – 1.41 of the Guidelines. The Guidance is applied not to transactions but to the dealings between the PE and other parts of the enterprise. So the examination of a dealing should be based on the *dealing* actually undertaken by the *PE and the other part of the enterprise* as it has been structured by them, using the methods applied by the taxpayer insofar as these are consistent with the methods described in Chapters II and III of the Guidelines. Except in the two circumstances outlined at paragraph 1.37, tax administrations should apply the guidance in paragraph 1.36 when attributing profit to a PE and so "should not disregard the actual *dealings* or substitute other *dealings* for them".

iii) *Internal “Reinsurance”*

183. The potential “dealing” that appears most problematic initially is “reinsurance” within a single legal entity. Arguably, however, the guidance developed in Part I provides a reasonable answer.

184. In the case of separate legal entities, reinsurance is a mechanism through which insurers can manage risks by shifting insured risks to other insurers in exchange for payment of premiums. By managing risks insurers can free up surplus and thus pursue other insurance contracts or meet regulatory requirements. Reinsurance is extremely common between both unrelated and related property and casualty companies.

185. However, within the context of a single legal enterprise, the conditions of any potential internal “reinsurance” dealing are likely to differ from the conditions found in reinsurance contracts between legally distinct enterprises. In particular, reinsurance within a single legal entity may well neither free up capital (or reserves) nor be recognised for regulatory purposes. It may be that internal reinsurance could serve a function similar to that of internal derivative transactions, by allowing the entity to centralise risk in a particular location where it can be managed by experts in that type of risk. However, it is unclear the extent to which this happens in practice.

[Comments are requested from the business sector regarding what business reasons might justify internal reinsurance.]

186. From a tax point of view, reinsurance shifts both the underwriting income and the investment income from the reinsured contracts from the ceding company to the reinsurer. There are significant incentives for firms to shift insurance income between jurisdictions via reinsurance. The taxation of insurance income differs substantially from jurisdiction to jurisdiction. In some jurisdictions insurance income may go almost entirely untaxed.

187. There is a consensus that the authorised OECD approach does not require tax authorities to treat as a “dealing” a bookkeeping entry that has no economic substance. The difficulty therefore is determining which, if any, internal reinsurance contracts will be treated as having economic substance.

188. In the context of independent legal entities, reinsurance essentially is the provision of capital from one entity to another. Accordingly, in order to enter into a reinsurance contract with a third party, a reinsurer must have both sufficient capital to assume the risk and personnel that make the underwriting decision to undertake the risk associated with the reinsurance. In the case of internal reinsurance, the capital of the entire insurance company supports the third party risk, so the amount of capital maintained or booked in each of the PEs is irrelevant to the issue of whether internal reinsurance should be recognised.

189. As indicated previously, under the authorised OECD approach, an internal reinsurance dealing, as any other internal dealing, should not be recognised unless it can be demonstrated that another part of the enterprise has performed the functions necessary to effect the transfer and re-assumption of risk. Since, as noted above, capital is not relevant to this question, the issue turns on whether there are in fact key entrepreneurial risk-taking functions performed by personnel in the location that is purportedly taking on the risk in connection with the reinsurance contract.

190. It seems that a functional analysis would reveal whether or not the risks associated with a set of insurance contracts had been transferred within an entity by examining if, for example, the underwriters in a headquarters had ongoing responsibility for evaluating whether and when to reinsure primary insurance in one of its PEs outside the enterprise. Concern has been raised, however, about applying this standard, as the decision to underwrite reinsurance can be undertaken by a single person.

191. A careful functional and factual analysis would be needed to determine the exact nature of any functions performed in relation to the internal reinsurance dealing. For example, was the function that of evaluating and determining the needs of one part of the enterprise for reinsurance? Was the function related to obtaining the necessary reinsurance and monitoring the ongoing reinsurance needs on a regular basis? Was the reinsurance simply of a structural type, e.g. 80% of all risks are automatically reinsured? What was the exact type of reinsurance, e.g. excess of loss, proportional, quota etc? What was the nature of any reinsurance commission received, e.g. was it in the form of a sales commission or did it relate to the costs and performance of the underlying insured business?

192. In the context of global trading, it is reasonably easy to determine when a market risk transfer has economic substance because there is on-going market risk management that must be undertaken by the traders on whose book a transaction appears. In the context of insurance, the management of the risk may not result in any identifiable activity until such time as that a new decision to reinsure (or some other decision related to transfer of risk) is undertaken. Therefore, in practice it may be difficult for the tax authorities, by undertaking a functional analysis, to determine whether risk has actually been shifted between a PE and its headquarters.

[Comments are requested from the business community regarding whether there are key entrepreneurial risk-taking functions in connection with the on-going management of a risk.]

193. In the global trading context, internal dealings may in some cases provide a mechanism for allocating marketing profits to a PE that conducts marketing, and ongoing trading profits to another portion of the enterprise that performs management of credit or market risk associated with the asset. Alternatively, a similar result can be obtained but without giving effect to internal dealings transferring credit or market risk under such circumstances. Under this approach, economic ownership of the underlying asset should be attributed to the location where the key entrepreneurial risk taking functions were performed, which would likely not be the location within the entity that conducts marketing, but none of the other key functions. The asset would be “economically owned” by this part of the enterprise, although arm’s length dealings would be recognised in respect of functions, such as marketing, performed by other parts of the enterprise.

194. Similar issues arise in the case of insurance, in that reinsurance dealings between one portion of the entity that performs marketing and another that performs underwriting could in some cases provide a useful mechanism for allocating profits between those locations. Alternatively, in cases where one part of the entity performs marketing but has no independent capacity to perform underwriting, another approach could be to consider that the part of the entity that performed the underwriting function should be viewed as the issuer of the insurance contract and a broker’s commission paid to the marketing PE. The situation might also be encountered in which both the PE and the head office jointly contribute to the initial underwriting of a risk, in that each performs significant, but distinct, underwriting functions. In such cases, under the authorised OECD approach, the two locations would split both the underwriting and investment income over time, thus making it unnecessary to recognise an internal reinsurance dealing to ensure the appropriate allocation of profits between the two locations.

195. An issue may also arise where it might be possible to free up substantial reserves by internal “reinsurance” of part of a PE’s underwriting by another part (for example, a second PE) of the enterprise of which the first PE is a part. This could perhaps happen where the regulator in the country of the second PE takes a more relaxed view of the risk involved in the underwriting, and so requires a smaller reserve against the same risk.

196. Where it is suggested that a “dealing” has taken place in these circumstances, it will be important to have regard to all the facts. In particular, it will be necessary to establish:

- whether the reinsurance by the second PE of the first PE's business could potentially have any regulatory impact. This will not, for example, be the case where the enterprise and both the PEs are in the European Union, since there will be a single regulator;
- in the event that the two PEs are separately regulated, whether the regulators would take a materially different view of the reserves required in respect of the business apparently reinsured by one from the other;
- whether the regulator of the first PE purportedly reinsuring business has recognised that reinsurance by, for example, giving credit for it on the same basis as credit would have been allowed for reinsurance with an independent insurer (with the same creditworthiness as the enterprise of which the PE is a part) and
- the facts presented to the regulator of the first PE and whether these accord with the facts determined by the tax administration.

It seems unlikely that a regulator would, for example, generally recognise an internal reinsurance for regulatory purposes without the insured risks subject to the reinsurance having been transferred from the PE subject to that regulator. And as elsewhere, a careful functional and factual analysis will be important.

iv) Applying Transfer Pricing Methods to Attribute Profit

197. Having established that a dealing has taken place and that the dealing as structured by the taxpayer would not need to be disregarded or re-characterised, the next issue is to determine whether the profit attributed to that dealing by the insurance enterprise is at arm's length. This is done by applying the guidance in the Guidelines on comparability, by analogy, in the insurance PE context. A comparison is made of the reward earned from *dealings* within the insurance enterprise with comparable *transactions* between independent enterprises, having regard to the 5 factors for determining comparability set out in Chapter 1 of the Guidelines.

198. Further, the authorised OECD approach provides that all methods in the Guidelines can be applied in the PE context in order to determine the profit to be attributed in respect of the dealing by reference to comparable uncontrolled transactions. In the first instance, the traditional transaction methods should be examined to see if comparables from uncontrolled transactions are available. In this context, the guidance at 2.7, 2.14 and 2.34 should be borne in mind where differences are found between the dealing and the uncontrolled transaction under respectively the CUP, resale price and cost plus methods. As noted, at paragraph 2.7, "The uncontrolled transaction may be comparable, if one of two conditions is met: 1 none of the differences (if any) between the transactions (*in the PE context between the uncontrolled transaction and the dealing*) being compared or between the enterprises undertaking those transactions could materially affect the price in the open market; or 2 reasonably accurate adjustments can be made to eliminate the material effects of such differences".

199. Whilst it is difficult to identify a service sharing the characteristics of writing insurance business, an insurance enterprise itself nonetheless utilises many services for which comparables can be found and makes use of its financial assets, in terms of investing them, in ways similar to other types of enterprise. The guidance at paragraph 1.19 of the Guidelines should therefore be applicable to services provided to insurance enterprises in most respects.

200. The second comparability factor, functional analysis, may be more problematic. An insurance business involves numerous functions, not necessarily carried out in sequential order. The trend for

increasing mergers and acquisitions reduces the number of potential comparables. Moreover, the dealings related to these functions may be structured in a different way from the way transactions between independents are structured. For example, the performance of related functions may be split between different parts of the enterprise whilst such functions would be performed together by independents. This makes it difficult to evaluate such integrated dealings in isolation and to apply reliably any of the traditional transaction methods. Such problems also occur with increasing frequency in transactions between associated enterprises and Chapter III of the Guidelines approves other methods (transactional profit methods) to be applied in situations where the traditional transaction methods of Chapter II cannot be applied reliably. More positively, the trend to outsourcing various parts of the value chain of an insurance business may create additional potential comparables at least for functions that have been outsourced.

201. With regard to the third comparability factor, contractual terms, no particular conceptual difficulties are envisaged in the insurance area, although there may be practical difficulties due to the lack of contemporaneous documentation or other evidence of the intention of the parties etc. The general guidance in Part I of this report should be followed in order to determine the division of responsibilities, risks and benefits between the parties to the dealing.

202. In some countries, internal dealings are often not well documented and this gives rise to the issue of how to determine the terms of any dealing. However, associated enterprises also do not always document transactions and this issue is covered by paragraph 1.28 of the Guidelines. That guidance can be applied, by analogy, by equating “terms of the dealing” with “contractual relationships”. Consequently, “where no written terms exist, the *terms of the relationship* of the parties must be deduced from their conduct and the economic principles that generally govern relationships between independent enterprises”.

203. The determination should be made very thoroughly because of the paramount importance of deciding the true division of risk when attributing insurance dealings to a PE. This is because the profits of an insurance enterprise derive primarily from the acceptance and successful management of insurance risk.

204. The fourth comparability factor, economic circumstances, is of particular importance when attributing profits to an insurance PE. Following the guidance of paragraph 1.30 of the Guidelines, different insurance regulatory regimes should be considered as potentially affecting market comparability. For example, it would not be correct to treat market data from a less regulated market as comparable to dealings in a more regulated market without making reasonably accurate adjustments for those regulatory differences.

205. It is not considered that there are any particular conceptual difficulties in applying the general guidance on the final comparability factor, business strategies, to attribute profit to an insurance PE. The issue is of importance because the strategic management of the insurance enterprise determines the nature, size and even geographical location of the risks underwritten. However, any relevant business strategies should be taken into account and should have been determined by the functional analysis under the first step of the authorised OECD approach.

206. The discussion above is based on the comparison of individual dealings with individual uncontrolled transactions. In practice, an insurance business usually consists of a large number of similar financial assets, risks and dealings. Accordingly, it may be particularly appropriate to apply the guidance on aggregating transactions at 1.42 of the Guidelines in the insurance context. For example, a comparability analysis could be made between suitably aggregated dealings and suitably aggregated uncontrolled transactions such as a portfolio of closely linked and similar investment assets.

v) *Rewarding specific insurance functions*

207. Having discussed in general terms in the previous sub-section how to apply the second step of the authorised OECD approach to attribute a profit to an insurance PE, this sub-section looks at some specific yet commonly occurring situations in more detail.

a) Underwriting insured risk

208. As noted in Section B-1(ii), the underwriting function is a key component of the acceptance of insured risk and the consequential requirement for surplus and reserves. The underwriting function is therefore crucial to the insurance business in that it is a prime determinant of whether risk is assumed at all by the enterprise and of the price at which it is assumed. Accordingly, the part of the enterprise that is determined to have performed the underwriting function is to be treated in the first instance as the “economic owner” of the insurance policy and so is entitled to the associated underwriting and investment income. As noted in Section B-2 there are a large number of other functions necessary to undertake insurance business. If these are performed by other parts of the insurance enterprise, then there are dealings that have to be taken into account in order to reward the performance of those functions. The rest of this section looks at those dealings in more detail.

209. There are still some unresolved issues as to exactly what functions have to be performed to amount to the performance of the underwriting/risk acceptance function. For example, simply issuing the contract or “rubber stamping” a decision made elsewhere does not warrant being treated as performing the underwriting/risk acceptance function. The essence of underwriting is the decision to accept insured risk and this will depend very much on the type of insurance business. For very standardised products, for example travel insurance sold through vending machines at airports, the underwriting/risk acceptance function is not undertaken by the vending machine but by the person who developed the product and set the insurance limits.

b) Risk management and reinsurance

210. This section focuses on the transfer pricing issues that would arise were internal reinsurance to be recognised under the authorised OECD approach (see Section D-2 (ii) for further discussion on that topic). When insured risk is reinsured with an independent enterprise, the reinsurance is recognised and the income statement and balance sheet of the PE whose insured risk is reinsured are appropriately adjusted. Where the reinsurance is with a third party reinsurer, an arm’s length price presumably arises. In the case of inter-affiliate transactions, comparables giving guidance as to the arm’s length price should, generally, be available. However, practical difficulties in establishing a suitable comparable may arise. For example, a small part of the insured risk is reinsured in the open market while a far larger part is “reinsured” with affiliates. In such cases it will be necessary to adjust the comparable to take into account the frequency and volume of reinsurance of open market transactions as compared with transactions between affiliates. Similar issues would arise in pricing “internal reinsurance” were it to be recognised in the absence of “matching” external reinsurance.

211. The decision to reinsure may be informed by advice and analysis provided by specialists (e.g. actuaries), located elsewhere within the insurance enterprise than the “reinsuring PE”. The cost of such services should be considered a legitimate expense of reinsurance and an arm’s length compensation should be imputed to the dealing for tax purposes.

212. As for other financial sector businesses, risk management and other related functions such as asset management will be an important factor in determining the profitability of insurance enterprises and

so would be rewarded accordingly. An issue arises as to the form that reward should take and in particular whether such functions should be rewarded by profit methods. Similar issues arise in global trading and the guidance given in Part III would appear applicable to ensure risk management functions are rewarded in accordance with the arm's length principle.

213. Issues also arise as to how to determine where operational risk is being managed. The risk that a liability may arise through the operation of a business resides with the part of the enterprise responsible for managing the activity giving rise to the operational risk. In the case of operational risk arising from the illegal activity of an employee, if a PE was responsible for managing the rogue employee then that PE is treated as assuming the operational risk. Any profit from performing functions related to the undertaking of that risk is properly allocated to the PE. To the extent that the head office performs functions that lead to the assumption of the operational risks that otherwise would be related to the activities of a PE, the head office should be compensated for assuming these risks. It should be possible to find comparables for such dealings as it is becoming common for enterprises to purchase insurance against operational risk from third parties.

c) Asset management

214. Asset management should produce few conceptual difficulties in relation to insurance enterprises. Such enterprises are generally considerably more conservative in their investment activity than, say, banks and generally prefer to lock into long term, lower risk investments rather than seeking trading profits by being continually active in the market. As such it should be possible to find suitable comparables from those organisations e.g. fund managers, which provide asset management services, though the particular requirements of the insurance business may necessitate adjustment to the comparables in order to make them reliable.

215. It should be borne in mind that following the authorised OECD approach (and as described in paragraph Section D-1(iii) of this part of the report) assets are attributed to PEs in an appropriate proportion to the level of insurance risk which the PE has assumed. The risk assumed will therefore reside in the PE so that "ownership" of the supporting assets and the associated investment income also resides in the PE. That part of the enterprise which manages the assets should therefore be rewarded appropriately for the investment management function by the part of the enterprise that is treated as the "economic owner" of the assets. This reward would be determined in accordance with the Guidelines.

d) *Product management/ product development*

216. It will be part of the functional and factual analysis to determine which parts of an enterprise designs and develops particular new products, the customer base at which the product is directed and the probability of a particular PE wishing to and/or benefiting from the new product. In other words, the salient facts in the functional and factual analysis will be which parts of the enterprise have helped develop the product, whether it is a generalised product marketed by all parts of the enterprise (and perhaps capable of being marketed by third parties) or whether it is a specialised product with a customer range limited to only specific PEs.

217. Compensation should be attributed to those parts of the enterprise engaged in development of the product. Generally, following the authorised OECD approach, the compensation should be on arm's length terms and should be provided by those parts of the enterprise which benefit from the product's sale. However, determination of the level of benefit enjoyed by a particular PE (and whether it ought to be treated as compensating the product developer for that benefit) is a question which will turn on the facts of the particular case. The guidance in Chapters VI and VII of the Guidelines (or Chapter VIII in the

circumstances where the product is developed by something analogous to a CCA) should be followed, by analogy, in such cases.

218. Once it is decided that an arm's length price should attach to the dealing then, depending on the level of sophistication of the product and the degree to which it has proprietary features, a market comparable may be found using the CUP method. Otherwise it may be necessary to arrive at an arm's length price using other methods authorised by the Guidelines.

e) Sales and Marketing

219. Traditionally, most insurance products have been sold directly (i.e. "one-to-one") by an agent or broker. Where one part of an enterprise markets the insurance product directly to third parties and then proceeds to contractually commit to and underwrite that business, the authorised OECD approach will attribute to that PE the underwriting risk arising from the sale together with an appropriate level of assets to support the risk assumed (including investment income associated with those assets).

220. However, with continuing development of telecommunications, it is becoming more common for one part of the enterprise to advertise or "market" products on behalf of the whole enterprise or other specific parts of it. The customer may be directed to approach a part of the enterprise other than the marketer in order to contractually commit to purchase of the product and, if the business is underwritten by the other part of the entity, the "sale" will generally be booked there (although the same effect could be achieved if the premium payments are received by the "marketer" and passed on to the "underwriter" less a commission to reward the marketing function). Subsequent premium payments may similarly be made to parts of the enterprise other than the "marketer".

221. If the enterprise as a whole is marketing a product on behalf of an independent entity (third party or an affiliate), the reward which the enterprise receives should be at arm's length (either directly if from a third party or, if it is an affiliated transaction, following application of the Guidelines). That reward should be allocated amongst those parts of the enterprise involved in the marketing and it should be possible to arrive at the arm's length compensation due to each "marketing" using the Guidelines and by making reference to comparable services available from unrelated providers.

222. Where one part of the insurance enterprise markets a product on behalf of another part of the same enterprise, or of the enterprise as a whole, the issues are more complex. In these circumstances it is very important that the facts are fully established by the functional and factual analysis. For example, one part of the enterprise may advertise a product from one jurisdiction (e.g. over the phone or internet) but instruct customers to conclude the contract with and pay premiums to a PE in another – possibly a third – jurisdiction. In these circumstances, under the authorised OECD approach the risk incurred in concluding the contract and underwriting the business will reside with the PE that performed the underwriting/risk acceptance functions. Assets to support that risk will accordingly be attributed to that PE. The cost of marketing the product sold will be an allowable expense for tax purposes and an arm's length compensation to the marketer may be imputed.

223. An issue arises as to whether for some of the more complex insurance products, there is a role equivalent to the "structuring" role in global trading as described in Part III of this Report.

[Views from business are invited as to whether for some of the more complex insurance products, there is a role equivalent to the "structuring" role in global trading as described in Part III of this Report.]

f) Support Functions

1) *Credit analysis*

224. The provision of credit analysis should be rewarded on arm's length terms. This function should not give rise to any conceptual difficulties and suitable arm's length comparables for the services provided should be fairly readily available.

2) *Treasury*

225. The treasury function is less significant in insurance than it is in, say, banking. In the insurance industry, the treasury function is normally not seen as a profit centre. One would therefore expect the treasury people to be primarily involved in raising finance and making it available to the profit centres. This raises the issue of whether treasury dealings with PEs should attract arm's length prices. The discussion at paragraphs 156-158 of Part I of this report will be helpful in this regard.

3) *Regulatory Compliance*

226. Regulatory compliance may be a requirement of the enterprise as a whole, of the PE itself (in respect of host country regulations) or both (i.e. the PE will be subject to both home and host country regulation). Where the PE is subject – because the enterprise as a whole is subject - to home country regulation, it is most likely that Head Office will undertake the regulatory compliance function. Under the authorised OECD approach it may be considered appropriate to allocate an arm's length fee to Head Office for providing the service. However, if the PE were a distinct and separate enterprise, it is not always clear that it would be subject to “home” country regulation and thus would not require assistance in ensuring regulatory compliance. One approach to this issue would be that compliance with home country regulation is one of the “same or similar conditions” required by Article 7 (2).

[Views of business are invited on this point.]

227. Where the PE has to satisfy the requirements of the host country, then an arm's length compensation will be due to whichever part of the enterprise undertakes the compliance work on behalf of the PE with a corresponding allowable deduction in computing the profits of the PE.

4) *Systems and development of intangibles.*

228. Although the role of information technology is significant (and becoming increasingly so) in the insurance industry, development of IT systems within the industry do not give rise to any conceptual difficulties not met elsewhere. Similarly, intangibles such as trade names are of very great value in the industry, but do not present any transfer pricing challenges not previously addressed. The detailed discussions in Section C-2(iv) (b) of Part 1 of this Report should be helpful in determining a suitable solution for enterprises using intangibles in conducting their insurance business.

5) *Other back office functions*

229. The back office support structure is of importance in the insurance industry, though perhaps less so than in banking. The various back office support functions need to be considered when attributing profit to the various parts of the enterprise.

230. As noted at paragraph 184 of Part II of this report “One area where there is a difference between the authorised OECD approach and the existing position arises from the fact that under the authorised OECD approach, the arm’s length principle is applied to determine the reward for performing that service. Application of that principle will take account not only of the price applied to the service but following the guidance in Chapter VII, whether, at arm’s length, both parties would have contracted for the provision of the service.....[T]he tests at paragraph 7.6 of the Guidelines will prove helpful in resolving such issues. Moreover, application of the arm’s length principle may indicate a price for the service rendered that is above or below the costs incurred by [other parts of the enterprise] in providing it (see paragraph 7.33 of the Guidelines”.

231. In practice, as noted at paragraph 185 of Part II of this Report, “[W]here the head office or other part of a bank provides centralised services to a PE that are similar to those provided by an associated centralised service provider in an MNE group, similar techniques may be used as apply to associated enterprises. However, services provided by a head office of an integrated enterprise may be different from those provided by the parent, or centralised service provider of an MNE group. Accordingly, whilst similar techniques can be used as for associated enterprises, CUPs are more likely to be unavailable, so that cost plus methods are likely to be particularly relevant”.

232. If the enterprise has a CCA type arrangement in respect of back office services, the guidance in Chapter VIII of the Guidelines on applying the arm’s length principle to services that are subject to CCA activity should be followed⁷.

6) *Claims Administration*

233. This is an important, though at times under-recognised, function in the insurance industry. Efficient loss adjustment and effective pursuit of claims against reinsurers can impact very significantly on profits earned. Clearly, if the PE performs this function itself and only in respect of business it has underwritten, no problems arise. However, the PE may perform the function on behalf of other parts of the enterprise or Head Office or another PE may act for it. Where the functional service is provided in those circumstances, the service provider is entitled to an arm’s length compensation. Some fee or commission basis suggests itself as a suitable methodology for attributing the reward. Arm’s length comparables may well be available and may provide an alternative basis for compensation of the service provider. If that is the case, the functional and factual analysis should provide a means for testing the suitability of the comparable against the specific circumstances of the PE.

⁷ See paragraph 185 of Part II, which discusses the possibility of a “CCA” within a single legal enterprise.

E ARTICLE 7(4) – IS IT UNNECESSARY

234. Article 7(4) provides that in so far as it has been customary to determine the profits attributed to a PE on the basis of an apportionment of total profits of the enterprise, nothing in Article 7(2) shall preclude continued use of that method, provided that the result shall be in accordance with the principles contained in Article 7, i.e. including the arm's length principle of Article 7(2). The Commentary reiterates that the approach is acceptable only if "the result can fairly be said to be in accordance with the principles contained in the Article" and stresses that the method "is generally not as appropriate as a method which has regard only to the activities of the PE".

235. In Section E of Part I of this report, the question was posed whether adoption of the authorised OECD approach would render Article 7(4) redundant. The conclusion as reflected in paragraph 300 is that, "Accordingly, under the authorised OECD approach only paragraphs 1, 2 and 3 of Article 7 are needed to determine the attribution of profits to a PE. A possible exception to the above conclusion, relates to the attribution of profit to a PE of an enterprise carrying on an insurance business. The Working Party has not yet finalised Part IV of the Report on the insurance industry but the view of most countries is that (given that under the authorised OECD approach only paragraphs 1, 2 and 3 of Article 7 are needed to determine the attribution of profits to a PE) there is no continuing need for Article 7(4)."

236. Section D-1(iii) of this part of the Report has now described how a level of assets and associated income should be attributed to an insurance PE, that level being appropriate to support the level of risk assumed by the PE. By hypothesising an appropriate level of assets (based on risks actually assumed by the PE) to the PE and then, following a full functional and factual analysis, attributing an arm's length price to dealings actually entered into between the PE and the rest of the enterprise of which it is part, it is considered possible to arrive at a close approximation to the profits which the PE would have made as a truly distinct and separate enterprise. The authorised OECD approach therefore appears to be in close accordance with the principles embodied in Article 7.

237. In the past, the use of apportionment methods authorised by Article 7(4) has been necessary because of the difficulty in arriving at an arm's length attribution of profits to an insurance PE. However, as this Part of this Report demonstrates, application of the authorised OECD approach appears to be capable of producing a result more in accordance with the principles of Article 7 than those methods. Accordingly, it is difficult to imagine circumstances in which such methods would be preferable to application of the authorised OECD approach. This leads the Working Party to the conclusion that Article 7(4) is redundant, even for enterprises conducting insurance business.

F. ARTICLE 7(7) – COORDINATION WITH ARTICLE 10(4) ETC

238. Article 7(7) of the OECD Model provides that:

“Where profits include items of income which are dealt with separately in other Articles of this Convention, then the provisions of those Articles shall not be affected by the provisions of this Article.”

239. Insurance companies, by the nature of their business, frequently invest in assets in connection with their business, that give rise to income falling within other Articles – in particular the dividend and interest Articles. So the question arises whether the authorised OECD approach has any application to those items of income where Article 7(7) applies.

240. The clear answer is “Yes”. In each of the other Articles referred to, there is a provision under which those parts of the Article which limit the taxing rights of the state where the income arises are disapplied where the income or gains is attributable to a PE in that State. And the Commentary on Article 7(7) reinforces this

“.....If the profits of an enterprise include categories of income which are treated separately in other Articles of the Convention, e.g. dividends, it may be asked whether the taxation of those profits is governed by the special Article on dividends etc., or by the provisions of this Article.

34. To the extent that an application of this Article and the special Article concerned would result in the same tax treatment, there is little practical significance to this question. Further, it should be noted that some of the special Articles contain specific provisions giving priority to a specific Article (cf. paragraph 4 of Article 6, paragraph 4 of Articles 10 and 11, paragraph 3 of Article 12, and paragraph 2 of Article 21).

35. It has seemed desirable, however, to lay down a rule of interpretation in order to clarify the field of application of this Article in relation to the other Articles dealing with a specific category of income. In conformity with the practice generally adhered to in existing bilateral conventions, paragraph 7 gives first preference to the special Articles on dividends, interest etc. It follows from the rule that this Article will be applicable to industrial and commercial income which does not belong to categories of income covered by the special Articles, and, in addition, to dividends, interest etc. which under paragraph 4 of Articles 10 and 11, paragraph 3 of Article 12 and paragraph 2 of Article 21, fall within this Article.....”

241. Since provisions such as Article 10 paragraph 4 provide that, in the case there dealt with, Article 7 applies if the holding in respect of which the dividend is paid is effectively connected with the PE, then Article 7 will apply to dividends (and interest) derived from the State where the PE is established if they are attributed to the PE.

242. From the Commentary to Articles 10 and 11 it is clear that for a holding to be effectively connected with a PE it does not have to be held at the PE. Since the authorised OECD approach is designed to establish what assets and income is attributable to the PE on the assumptions laid down in Article 7, it would be surprising if the provisions of Article 10(4) or 11(4) permitted a different answer to be given than if Article 7(7) did not exist. This was clearly not the intention behind these Articles. It is suggested that the Commentary on these Articles might be made explicit on this point and say that where income or gains are attributable to a PE by virtue of Article 7 then they will automatically be regarded as effectively connected within the meaning of Article 10(4) etc.