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Annex 1 to doc MU 5250 (09/05)

Paris, 13 September 2005

OECD Discussion Draft of the Report on the Attribution of Profits to a Permanent Establishment - Part IV (Insurance) Issued June 27, 2005

Dear Mr. Owens,

The COMITÉ EUROPÉEN DES ASSURANCES ("CEA") is pleased to respond to the request for comments on the OECD Discussion Draft of the Report on the Attribution of Profits to a Permanent Establishment - Part IV (Insurance).

The CEA is the federation of national insurance company associations in thirty three European countries. This document reflects the position of our member associations and of their member insurance companies, and is the outcome of intense discussions on this subject within the insurance industry.

Reading the Draft Part IV, it is evident that the Secretariat and Working Party ("WP6") members have gone a long way to understand the business of insurance. The description of the functions of an insurance enterprise as documented is well drafted and reflects the business practice of most operations around the world, making the paper broadly accurate, no matter the jurisdiction or regulatory environment. We compliment the effort to date on this extremely difficult subject.

The questions raised by the OECD in the Note to Business Commentators are addressed below, within the applicable sections of the Part IV Draft organization. The CEA notes that Draft Part I is still in the process of being adjusted to address substantial business comments, which makes our task and the following comments necessarily provisional.

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A. Working Hypothesis ("WH")

As discussed in our submission in autumn of 2004, regarding the proposed finalisation of Part I, the CEA is concerned that testing of the authorized OECD approach by application to the insurance industry is not yet complete. The CEA believes that with respect to the insurance industry, it is not accurate to state that "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", as in Paragraph 6 of the Preface. The present Draft Part IV, in the CEA's opinion, does not complete the testing process, as testing in such a specialized area as insurance should include discussions with industry specialists.

As communicated in earlier submissions, the CEA is in agreement that the hypothetical distinct and separate enterprise approach, as set out in Draft Part I, is generally the appropriate methodology to be used in determining the profits to be attributed to a permanent establishment of an insurer. However, the difficulties in applying this approach to our industry in practice are considerable, and the Draft – while going quite a way to explain and analyse insurance – does not yet resolve them. As a result of the lack of a global framework for insurance capital requirements and regulation, our members fear that without more explicit guidance on how to apply the Authorized OECD Approach, the insurance industry will have less clarity after the publication of Part IV rather than more.

The CEA request that undue complexity of the analysis for attributing risks, assets, liabilities and capital be avoided whenever possible. Complexity not only adds administrative cost for the taxpayer, but also creates uncertainty - possible double taxation and tax controversy cases between two or more tax authorities.

B. Factual and Functional Analysis of an Insurance Business

The CEA agrees that as a consequence of adopting the Authorized OECD Approach, a facts and circumstances analysis is the most appropriate way to clarify the tax base. Specifically, the CEA suggests that Part IV recognize that the insurance industry, perhaps more extremely than most other industries, faces business cycles that impact the level of income <u>and/or</u> loss over time. There is inadequate recognition throughout Part IV that underwriting <u>can be loss</u> making and it should be emphasised that the combined ratio [sum of the loss ratio (loss expense/premiums) and expense ratio (underwriting expenses/premiums)] can be greater than 100%. This is also true for reinsurance, and in that regard there should not be an assumption that a ceding commission will produce a profit. It can be the case that poorly performing business is retroceded, as a protection to further capital erosion, which may even trigger a ceding expense, rather than commission, payable by the ceding company. Such factors should be considered part of the facts and circumstances analysis required to appropriately perform a functional analysis, in order to ensure that the losses arising from a business are allocated to the same jurisdiction as its profits.

Functions Performed

21 [Comments are invited as to the factual accuracy of the analysis of the most important functions of the modern insurance industry.]

As mentioned above, the work performed to date, describing the most important operational functions of an insurance enterprise reflects a good understanding of the subject matter. In the CEA's opinion, this portion of the draft is moving in the correct direction. Nonetheless, the CEA does have feedback on this section of the Draft and is prepared to provide more comprehensive information on specific topics should WP6 desire.

To begin, the CEA would like to stress that insurance is not the intermediation of risk, our industry accepts risk. This makes the insurance industry different from banking. This point should be reflected by revising paragraph 22.

The CEA notes that the current Draft describes the operational functions of insurance, but does not include any text covering the strategic functions performed, such as the creation and implementation of a business strategy. Clearly WP6 recognizes that business strategy is important: in paragraph 33, the point of "strategic business goals" is mentioned. Again in paragraphs 47, 76, 92 and 205, "business strategies" are mentioned. Finally, in paragraph 205, the statement "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" is made.

Given the fact that the strategic setting functions precede all currently documented functions, the CEA suggests the addition of a new paragraph at the beginning of B-2 addressing these functions. The relevant functions are:

> Establishing the strategic agenda for the organization: this agenda is prepared by top senior management, and reviewed regularly. The strategy typically includes capital allocation, staffing, pricing changes and the related timing, responsibilities, etc., all of which will determine what operational functions will be performed. Without a specific business strategy, there is no differentiation between insurance organizations
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> Ensuring the strategy is implemented: for instance, there must be a process in place which ensures that the decisions on capital allocation and pricing changes are actually properly considered in the regular update of underwriting guidelines. Without a regular update of guidelines, individual underwriters will naturally attempt to maximize both premium volume and projected net income for their assigned responsibility, disregarding potentially better opportunities outside of their area. Also, there must be a process of tracking and controlling performance against the plan.

The management of a business strategy for a multinational insurance enterprise transcends jurisdictional borders and ensures the entire operation is as profitable as possible. This direction setting is not visible at client level, where the enterprise accepts risk, and therefore needs to be included in the factual and functional analysis of an insurance business, to ensure completeness and avoid uncertainty in interpretation.

As a general point, paragraph 21 should be reworded and the entire document more integrated to cover all insurance activities equally. The references and occasional emphasis added regarding direct life insurance and the business of reinsurance throughout the document are not necessary for a document applicable to the broad market of insurance. Non-Life, Life and Reinsurance deal with different products, have different value propositions and clients, and thus different regulatory frameworks, but they all share the same basic business functions. For instance, product development for customers also occurs in reinsurance (Para. 25, last sentence).

Perhaps a better understanding of how and why insurance has developed into the market it is today – experiences of large losses, which triggered the need for reinsurance to spread the risk, ultimately leading to the necessity and ability to share the risk in the open market (via securitizations) – could be shared during a limited industry meeting, giving WP6 more background on the key functions of an insurance operation. Many of the core functions of an insurance operation, forming the factual and functional analysis, can be best understood with a historical perspective.

As stated previously, the CEA supports the text as currently drafted, describing the functions performed, but recommends adding a paragraph which recognizes it is not possible to describe every function performed by all organizations exhaustively in an industry as complex as insurance. The CEA is concerned that functions not described in the document may be otherwise unduly disregarded in the concrete case.

39 [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).]

Insurance-linked securities (ILS) are an effective way of increasing insurance capacity. Since its inception in 1996, the market for ILS has witnessed worldwide issuances in excess of USD 8.1 bn. A large number of the securities issued have been in the form of catastrophe bonds (cat bonds), whereby the capital markets provide capacity for low-frequency, high-severity natural catastrophe exposures.

The market for cat bonds was first developed during periods of reinsurance capacity shortage in the wake of two major catastrophic events – Hurricane Andrew in 1992 and the Northridge earthquake of 1994. The cat bonds increased the ability of insurers to continue providing insurance protection while transferring the risk to investors. For insurers, reinsurers and an increasing number of corporations, cat bonds provide multi-year protection against natural catastrophes with little credit risk. For investors, these bonds offer attractive returns and, thanks to low correlation, reduced portfolio risk.

Special purpose vehicles are typically used in such transactions to enable the bundling and ring fencing of the risks to be securitized.

Assumption of Risk

As well described in the Draft Part IV, an insurance enterprise assumes a whole series of risks of which underwriting is only one type (albeit the most apparent). Underwriting risk may be classified into two levels of risk. The first level is that in which local business units, through their underwriting activities, build risk portfolios which are backed by technical reserves. However, in the case of a large international insurer, these risks are aggregated and managed at worldwide level. This consolidated underwriting risk requires separate management and is not governed locally. The other types of key risks found in an insurer are investment risk, market risk, liquidity risk and currency risk. The management of these risks is typically centralized in one location and not done by the local business units.

Agency PEs

The CEA joins the banking, investment banking and non-financial services industries in expressing concern at the inclusion in Parts I-III of significant amounts of text on dependent agent PEs and the implication that many such dependent agent PEs exist. This issue is not exclusive to insurance and therefore is best addressed as a revision to Part I. Since the scope of the current drafting has been limited by the OECD to considering how much profit is attributable to a PE once a PE has been created through a dependent agent, all of paragraph 62 and most of 63 should be removed.

C. Application of the Guidelines to Insurance Companies Operating through Subsidiaries

The released Draft Part IV includes comments on reinsurance transactions between separate legal entities of a Group. It discusses when such a transaction may be disallowed, and contains some industry-specific transfer pricing comments. No other Parts (I, II or III) attempt to modify the OECD Transfer Pricing Guidelines for Multinational Enterprises and insurance should not be treated differently in this regard. Therefore, it is the view of the CEA that Section C should be deleted.

D. Applying the Authorised OECD Approach to Insurance Companies Operating through PEs

¶106 [The types of risk which require surplus and how to determine the quantum of surplus and its location within a single enterprise.]

All types of insurance risk require capital. The amounts depend on the type of business (risk) being underwritten, regulations, and whether the enterprise decides to reinsure the risk.

From a pure actuarial perspective, the expected frequency and amount of contracted risk (loss), determines the amount of reserves and capital to be held. But the factor which ultimately determines where and how much capital an insurance enterprise is required to hold is the local insurance regulation. Regulators establish rules on the principles to be applied when calculating the amount of required capital. Reports of the application of these rules are filed at least annually and possibly quarterly or monthly. In some regulatory regimes, actuarially calculated reserves are compared to the admitted assets (not all assets are counted for the required capital calculation because of their low credit quality, liquidity, risk profile, etc.) of an enterprise, and the excess of admitted assets over liabilities, including the calculated reserves, is surplus. Other regulations use risk-based capital models, with a variety of calculations.

Most jurisdictions have regulatory surplus rules for branches. When there are no such rules (e.g. within the EU), the branch host country regulator relies on the home country regulator for supervision, so that in the absence of host country insurance regulations, home country regulations will apply. Accordingly, the CEA recommends designating the applicable regulatory surplus rules as a safe harbour.

The impact of regulation, and in particular host country regulation, on the conduct of insurance business.

Impact of Regulation

As the Draft Part IV recognizes, there are substantial limitations to the entrepreneurial freedom of organizing insurance business activities as a result of regulatory controls in the various countries. These limitations are quite significant, and cover both the asset and liability sides of an insurer's balance sheet. The regulatory controls deal with the calculation of reserves and capitalization requirements, and they often also limit the insurer's choice of what investments to hold. In addition, regulations also contain rules such as the experience and educational background of senior management and key individuals (e.g. chief actuary).

Regulations mean that the insurer requires a licence to conduct business. Even if the host state does not apply its own regulatory rules to a PE of a foreign insurer, this does not mean that the enterprise is doing business without a licence. The host state in these circumstances (e.g. EU) only refers to the regulatory rules and control of the home country; the reason being that the home country regulations are similar to the ones in the host country and thus ensure an acceptable level of control to the host country legislator.

Accordingly, the regulatory filing can, in most of the cases, be used as the starting point for tax. In these regular cases, conducting a full factual and functional analysis appears to be too onerous administration and the CEA would welcome a safe harbour, allowing PEs to calculate their taxable results in line with the regulatory return.

The CEA notes (in paragraphs 96 and seq of Draft Part IV), that the regulatory return in the host State would not be determinative of the measurement of the taxable result. This is the direct consequence of applying the Authorized OECD Approach. Accordingly, it should be made clearer in the document that the functional analysis cannot only lead to more business taxed in the host country than reported in the regulatory statement but also to less. It may well be that host country regulations require local reporting of a business, even though only very limited functions are actually performed. If WP6 wants to depart from using the statutory return as reference, a specific statement in Draft Part IV is needed, stating that the allocation of income can differ from the regulatory position. Otherwise, the CEA fears that in practice some fiscal authorities may be reluctant to depart from the regulatory return.

Creditworthiness

The CEA does not agree with the assertions within Para 125 that the creditworthiness of a PE is the same as of the enterprise as a whole. Since no two PEs are ever likely to have identical risk portfolios and/or have the same level of local capital, as required by local regulations, it is impossible to envision how a single PE could maintain a credit rating equal to the entire enterprise. This has been recognized, for example, by rating agencies who are able to differentiate between a PE and its HO.

Attribution of Assets

It is important to recognize that not all assets of an insurance enterprise used to support the reserves and surplus are income-producing assets, or equally income-producing. For example, debtors held on the balance sheet or deposits held as required by local regulators are typically either non-income producing or substantially lower risk, and thus generating a lower return than the remaining invested assets. Such losses need to be attributed to the respective insurance business too.

Any asset attribution must also consider that some investments are location-specific because of their favourable tax treatment. An enterprise must be allowed to identify such assets that are location-specific and hence not attributable.

Attribution of Capital

Regarding the allocation of capital, we join the banking community in requesting that the method of allocating capital to a PE result in a total allocation no greater than the capital of the entire enterprise. In insurance, as described above, no standard definition of capital exists, nor are there any global insurance industry benchmarks as to what constitutes minimum or free capital. It is also not possible to allocate capital to business lines and then to PEs per business line in a uniform way. A significant reason for this is that the insurance industry lacks a global capital framework like Basel I. Accordingly, the allocation of capital based on an allocation key is not really feasible in practice.

¶164 [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]

In the CEA's view, the most practical solution in most circumstances is to utilise the local regulatory minimum capital requirements of the country in which the PE is situated. Should no local regulations exist (because, as discussed above, the host country refers to the home country regulations for effective supervision), then the regulations of the home country should be used. The CEA commends WP6 for choosing such a practical method, the quasi-thin capitalization approach, as a mandatory safe harbour method. Designating a safe harbour, on which taxpayers can rely, will remove some of the uncertainty created in the context of Part IV. Were the OECD to decide to designate only one method of capital allocation as the authorized OECD approach for insurance, the CEA would recommend that the quasi-thin capitalization approach be the authorized OECD approach.

¶175 [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]

Asset management is not unique to the insurance industry. This function is sometimes outsourced by an insurance enterprise and, in all but rare cases, not a KERT of the insurance enterprise. Compensation should be on an arm's length basis using the widely available third party data on the remuneration for investment management services. Selection of the third party data should keep in mind the types of assets being managed and expected duration of the portfolio, which is typically matched to the expected payment of the reserves.

The yield on reserves and capital attributed to the PE should take into consideration the restrictions imposed by local legislation. Identical to the point on the attribution of capital, the most practical solution is to utilise the local investment restrictions to determine how allocated capital is invested in the country in which the permanent establishment is situated. Insurance regulatory rules typically place restrictions on the types (asset classes and diversification requirements) of investments that can be made. Further, as mentioned above, an enterprise must be allowed to identify investments which are location-specific, because of the particular tax rules, and hence not attributable. To allocate investment income using a flat yield, without consideration of this point, will result in an over-allocation of taxable investment income.

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

Commercial Rationale for Internal Reinsurance within a Single Enterprise

There are many different commercial reasons for inter-branch reinsurance.. Internal reinsurance is the tool which allows centralization of risk management. Bringing business from its place of origination to a central location will allow the risk managers to pool a category of risks that should be reinsured externally, thus optimizing the pricing on external reinsurance coverage. Also, internal reinsurance will allow a portfolio-based management of the insured risks beyond country barriers.

In practice, an insurance company will not retain all risk, but purchase a fair amount of reinsurance; a branch often will not, because it is backed by the enterprise as a whole. For tax purposes, such "backing" needs to be recognized; otherwise there is an apparent inequity between PE's and legal entities. The most appropriate way of mirroring this situation is to allow recognition of internal reinsurance dealing as actually occurs between legal entities.

A permanent establishment should be permitted to elect the manner in which its business will be funded (capital contribution, reinsurance, debt) in the same way as a subsidiary. Consequently, not only should tax recognize internal reinsurance dealings, but also internal financing between head office and permanent establishment. This reasoning would be in line with the logic applied to transactions between different offices of banks.

Under the Authorized OECD Approach, if an insurer's foreign branch performs the same function as a foreign subsidiary, there should be no major differences in the taxation right allocated. If applied consistently, PEs and subsidiaries should also be treated equally when it comes to internal reinsurance.

Intra-enterprise reinsurance is a very important tool under the hypothetical distinct and separate enterprise approach to obtain an arm's length result for tax purposes. By recognizing intra-enterprise reinsurance dealings, it can be ensured that taxation occurs where the management of the business (risk & capital management) is actually performed. Intra-enterprise reinsurance reflects the transfer of the functions actually performed from one country to another, and thus ensures that tax revenues will be fairly allocated among the countries in question.

As a final point on this subject, the implication that reinsurance within a Group is tax motivated is misplaced and should be carefully considered based on the merits of the actual business environment. The CEA's explanations of the reasons for inter-branch and inter-company reinsurance should enable WP6 to delete or significantly modify the last sentence in paragraph 20 and delete Part C.

KERTs

It is not easy to comment on paragraphs 75-96 when WP6 has stated that it is refining the definition of KERT. The CEA requests to be allowed to comment on the application of any re-definition of KERTs to the insurance industry following its release under Part I. Nonetheless, we have provided a limited number of comments based on the assumption that the purpose of KERTs is the allocation of capital and not of income, for which existing transfer pricing guidance and Part I internal dealings analysis guidance is sufficient for addressing this matter.

192 [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.]

The acceptance and management of insurance risk are KERTs in an insurance enterprise. The CEA therefore can confirm that there are KERT functions in connection with the on-going management of risk. As indicated previously, the management of the reinsurance programme within an enterprise, both by insurers and reinsurers, is an essential part of the on-going management of risk after the initial acceptance of risk. The CEA does not view the functions of investment of premiums, contract and claims management or support processes as KERTs of an insurance enterprise.

Importance of Risk Management (Active Management)

Paragraph 75 states that a KERT will require active decision-making with regard to the taking on, and day-to-day management of, the individual risks and portfolios of risk that have been identified as the most important under the factual and functional analysis. The CEA is of the opinion that the requirement of “day-to-day management” does not accurately reflect the business reality of insurance. In insurance, once underwritten risk is on the books, it typically does not require daily attention. In practice, insurance companies have a controlling and management process in place which ensures regular monitoring and, if needed, action taking but, because of the duration of the business, there is no necessity for daily action. The CEA suggests replacing the term “day-to- day management” by “active management”.

For the sake of clarity, it should be emphasised that as a consequence of applying the Authorized OECD Approach, the underwriting function (the acceptance of risk under specific terms and conditions) is not be confused with the ability of a PE to carry risk from a regulatory perspective. For example, if a PE consists of a very small team of underwriters subject to close controls and precise instructions from head office, then the presumption should not be made that the active management is within the PE, based purely on the – regulatory definition - ability to carry risk. A more specific example might be a situation where a call centre employing 1,000 people in a PE is working to guidelines set by 10 people in a different part of the enterprise (possibly Head Office). Although it is the call centre personnel who physically place the insured on cover, the active management function for this insured risk is clearly with the 10 people in the Head Office providing the guidelines and authorisation limits, and hence the taxing right over the business result should be with the Head Office, with a proper fee for the call centre. The CEA recommends that these types of situations be addressed within the Section of Part IV dealing with the recognition of key functions and in particular KERTs.

Split Functions

The CEA is of the opinion that Part IV needs to provide more specific practical guidance on how the insurance industry should deal with the situation where a KERT is split between two parts of the enterprise. Due to the complexity of this issue, we would request that it specifically be discussed during a limited industry meeting.

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

It is fair to assume that for complex products such a role will, in essence and independent of the label "structurer", exist. It will depend very much on the organizational model used, the line of business in question, and other facts and circumstances (how material this role is, whether or not it is part of Sales and Marketing, Product Development or Underwriting function).

226 [Views from business are invited on this point.]

The CEA agrees that, more often than not, the insurance enterprises use the Head Office to centralize regulatory compliance. In these cases, where the home office rules apply to the PE operating in a host country and the Head Office centrally manages compliance with these rules, an appropriate arm's length fee to the Head Office would be required for providing the service.

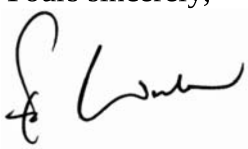
E. Possible Removal of Article 7(4)

The use of an apportionment of the total profits, as currently allowed under narrow conditions by Article 7(4), should not be dismissed without thorough analysis, since it has the big advantage of offering a simple solution in highly complex circumstances. The CEA would welcome the opportunity to support the OECD in the respective testing and analysis of this very important subject.

3. Conclusion

It is the CEA's view that the OECD should strive to adopt principles that are consistent, prevent double taxation and are not unduly cumbersome to administer by the average compliant taxpayer. We recognize this is not an easy task. Based on the current Draft, normally compliant taxpayers will find it difficult to determine how the proposed rules would apply within the insurance environment. The CEA hopes to have answered the questions of WP6, fully or at least partially, but would like to point out that it is not really possible to address every point exhaustively in writing, as we may focus on items which are not really of key interest to WP6. We would appreciate the opportunity to meet with you to discuss our comments.

Yours sincerely,



Franz-Josef Werle
Director

Cc: Mrs Silberztein