

# ZURICH FINANCIAL SERVICES

## Comments on the OECD's

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

#### *Part IV (Insurance)*

*Released for public comment by the OECD on Monday 27 June 2005.*

These comments arise in the same order, using the same annotation, as the OECD draft.

#### *Note to Business Commentators*

*Comments are particularly invited by the OECD on the following issues:*

*The factual accuracy of the analysis of the most important functions of the modern insurance industry.*

This is on the whole a commendable summary of the insurance industry. Some key points need to be added to the text in a highlighted form:

Any summary, no matter how worthy, must inevitably be subject to change over time.

The analysis must not be taken to be a definitive analysis of the activities of any or all insurance enterprises. It should be clearly stated to be a guide, subject to change, and/or not necessarily correct in all cases. As always in transfer pricing, particular facts and circumstances must be taken into account.

A key point to be added to the factual analysis is that the insurance industry, perhaps more than any other, is subject to cyclical performance. There are the notorious insurance industry cycles, plus investment performance cycles. These can have a massive impact on results.

In particular, in downcycles insurers can lose large amounts of net assets/surplus. Even regulatory requirements for assets/surplus have to be relaxed at times. In such facts and circumstances it may well be the case that a PE will share in this insurance entity loss of assets/surplus. There is a tendency for fiscal authorities to require some formulaic attribution of assets/surplus to PEs, particularly where any quasi-thin

capitalisation approach is used. Clearly it would not be right for any such formula to be unaffected by the facts and circumstances of poor financial results. In effect, an unchanged formula would attribute assets/surplus to PEs at the expense of the rest of the entity, leaving the home office to bear all losses. Nor would a comparable company have its assets/surplus "replaced" in such an automatic way.

Finally, it should be noted that attribution to a PE might lead to attribution of losses, not profits. This could apply to attribution of insurance business, which cyclically is often written at a loss. Equally it could apply to attribution of assets, since investment yields can be negative. Similar points might apply to other sectors too.

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

Regulation is absolutely fundamental to the conduct of insurance business. It determines usually strict parameters for what business can be written, where, by whom, and in what manner. An exception to this general position is that reinsurers tend to be lightly regulated in comparison with insurers. The logic of this is that the original insurers are liable to policyholders, and the primary focus of regulators is to protect policyholders.

The role played by host regulation varies considerably, from country to country, and changes over time.

Some potential host regulators in effect do not allow branches, or very severely restrict their scope, in order to remain the prime or only regulator of local insurance. This approach tends to be outside the OECD, and a declining pattern.

At the opposite end of the spectrum host regulators in the EU leave the primary responsibility to any home EU regulator, by virtue of the EU Insurance Directives. In the case of non-life insurance this is more marked than in life insurance, as an EU non-life branch does not even have to produce a host country branch regulatory return (under the Third Non-Life Directive). In effect virtually all regulation is left to the home country, under the "lead supervisor" concept. Most non-EU countries in Europe have signed up to this arrangement, so it is in effect close to being a cross-Europe norm.

The EU is also working on a co-ordinated approach to capital requirements, known as the Solvency II project.

In between these opposite ends of the spectrum a typical host regulation requires a host regulatory return, and the maintenance of host surplus, usually "localized" in the host country. This would be the case, for example, for any non-European entity with a branch hosted by the UK.

It is also worth noting that insurance regulation can have perhaps surprising effects on how insurers operate. For example, it is quite common for major UK insurers to have no staff. Insurance regulation often limits an insurer to only carrying out such functions as are necessary for or directly related to its insurance business. The policy

logic is that policyholders should not be at risk from potentially risky non-insurance activities of an insurer. Strictly this means that insurer A's staff should not be doing anything but insurer A's insurance business. A common group arrangement is therefore for service companies to employ all the staff working for more than one insurer. Similarly an insurer's premises are likely to be owned by a property company.

***The commercial rationale for internal reinsurance within a single enterprise.***

Reinsurance from one part of a single legal entity to another part of the same entity is of course not possible from a legal perspective. Commercially, it can often make a great deal of sense.

This might be for internal reasons, such as moving business to the "economic" rather than "legal" owner of the business.

A very typical scenario arising in commercial lines insurance (to companies, especially large multinationals) is that an entity in home country A might negotiate a worldwide contract with a MNC. The MNC will typically negotiate this centrally to obtain economies of scale in pricing and transaction costs; for use of specialists; and to take an overall view of risk. (typically, what might look a big risk needing insurance in a small part of an MNC might not need insuring at all, or less insuring, or insuring as part of a bigger pot, at world level.)

The MNC will want to negotiate with one part of a major worldwide insurer. However, regulation is still country-by-country, so the insurer will have to translate one large contract into usually at least one contract of insurance per country covered. Local regulation will require this to be a host contract written by a host entity or branch. The insurer will naturally try to arrange this first with its own branches and/or subsidiaries. In some cases this will not be possible, and so a third party insurer with the appropriate license will be asked to "front" the business. This involves writing the host insurance, and then reinsuring 100% to the main contract insurer. The host insurer will take a commission to cover its costs plus some margin for doing this. Regulation might limit the reinsurance to, say, 90%.

In the case of a subsidiary this arrangement will be replicated, with reinsurance to the "home" insurer. Provided that arm's length commission is applied, exactly as if the "fronting" company were third party, then there should be no tax concern with this "fronting". It is a very common commercial arrangement.

However, suppose that the fronting host insurer is a branch of the main home insurer. The reinsurance would not be possible legally. Nonetheless, commercially both the branch and the home office would like, for purely commercial reasons, to replicate the third party and/or subsidiary arrangements.

From a tax perspective, it would seem that in these facts and circumstances the rationale for recognising an internal reinsurance is overwhelming. The branch is to be hypothesised as a distinct and separate enterprise operating under the same or similar conditions. It may well be that on one MNC contract part is fronted by one or more third parties, part by one or more subsidiaries, and part by one or more branches. The

branch as a hypothesised distinct and separate enterprise would therefore enter into exactly the same reinsurance, but this time as “internal dealings”, as would the third parties/subsidiaries. To recognise that reinsurance for tax, and ensure the same rewards for branch and subsidiary as for third party, would be to exactly observe the Transfer Pricing (“TP”) Guidelines.

Perhaps a little less clearly, a branch will often act as a “selling agent” for its own home office. The appropriate comparable may be more an “agent” than an “insurer” for TP purposes, as follows.

A large part of insurance, probably the majority, is sold at the point of sale not by insurers directly, but by a host of agents. This is especially the case for life insurance and non-life personal lines (household, motor). Many agents are independent, and so no TP issues arise. Dependent agents that are not branches will usually be operating in much the same way as independent agents, and so TP requirements should be satisfied by analogous commission levels.

PEs which arise from branches of insurers often, but not always, also operate in a similar “selling agent” manner. Typically they will be small in comparison with the entities of which they are part. Underwriting guidelines will be set for them by home office. Premiums net of expenses may well be invested by home office. They may be able only to sell in a very controlled manner and at controlled prices. Call centre staff, for example, often have no more freedom of action when contracting insurance than a website equivalent. Personal lines are increasingly sold over the internet, with no human intervention by the insurer, other than the setting of the original underwriting by software. Usually there is a telephone alternative, sometimes at the same price, sometimes with a price discount for the internet sale.

The important point is that no term of insurance, or just an automatic price discount, varies from internet to call centre. So the call centre, or branch/PE, may be taking no decision of substance in writing insurance, other than mechanically implementing home office policy in exactly the same way as a website/server is doing. In such a case, although legally the branch writes the insurance, by force of host regulation, commercially and for tax purposes the correct TP result is for the website/server, or branch/PE, to be rewarded as a provider of a sales service. A functional and factual analysis should produce the same result for this type of branch/PE activity. This correct TP result would be most readily achieved by allowing internal reinsurance from the legal writer (the PE) to the economic writer (the home office).

In an even more general scenario, it is probably a universal desire for a legal entity to bring together in a centre of excellence the big decisions which control the whole enterprise. This almost inevitably has to be home office, as that is where the seat of government is. Entities vary, including over time, as to the extent to which they operate in a centralised way, but universally there is some degree of centralisation, as there is only one company board.

For insurers, it is vital for the centre to be in control of risks taken by the enterprise anywhere. This typically leads to tight controls over any branches.

Home and host regulation often reinforce this tendency. The home regulator insists on the head office operating overall controls, and the host regulator will typically want evidence of the commitment of the head office, often including direct contact on important matters. In such circumstances, reinsurance of business from branch to home office would facilitate such matters as home office taking an overall view of the need for reinsurance protection of the whole entity, foreign currency positioning on a whole entity view, economies of scale in managing the whole position, etc. Again, a functional and factual analysis would suggest internal dealings to produce the right TP results.

Of course, some PEs, or some PEs re some lines of business, will carry out more than these limited roles. In such cases, it might not be appropriate to recognize an internal dealing. All will depend upon the facts and circumstances of any particular case.

***The use of alternative risk transfer mechanisms, such as catastrophe bonds.***

We have no particular comments. The development of the ART market has provided insurers with further means of managing their overall risk positions, and allowed investors other means of participating in insurance. Factual and functional analysis should show to what extent such activities should be attributed to PEs or home office.

***The types of risk which require surplus, and how to determine the quantum of surplus and its location within a single enterprise.***

Risk affects insurers' calculations of surplus in the following principal ways.

Reserves. Risk of paying out claims leads to the calculation of claims reserves, as an estimate of liabilities to policyholders.

Margin in reserves. To the extent that there is perceived to be significant risk of claims payments being greater than "best estimate" claims reserves, then various other reserves may be provided for above "best estimate". These could include "equalisation reserves", "catastrophe reserves", or simply "margin" in reserves.

Discounting. Reserves may be discounted to reflect that the passage of time will allow the insurer to earn investment income to partially offset the cost of claims. This discounting may be at the company's investment return rates, in effect bringing investment risk into reserve calculations. It may also be affected by regulators, as discussed at paragraph 158, in effect bringing risk calculations re asset values and investment yields into the calculation of reserves.

Assets. Risk can also affect the valuations put on assets, especially for regulatory purposes. On the one hand, an insurer might provide for some element of non-recovery or valuation of an asset. On the other, regulatory requirements might include a nil valuation of debtors older than, say, 6 months. In effect, the regulator, for prudence to protect policyholders, imposes a lower value than normal accounting would suggest.

Surplus. Regulatory requirements for surplus start with reserves and assets as risk-adjusted above. A further level of prudence to reflect risk is then typically introduced in a number of ways.

- Reduction of asset value on the basis of “too many eggs in one basket”. An insurer might be only able to value a large asset, such as a major subsidiary, at a reduced level to reflect the risk of too much value in one asset.
- Surplus required on some calculation of risk-weighting of the whole book of business.
- Increase of surplus required because a particular type of business is considered riskier than others, e.g. public liability business.

As described above, host regulators may impose all this on host PEs. However, as the draft report says (para 161), the host regulatory requirements and return will focus on the legal fact of the branch’s writing of local business, and not on the underlying factual and functional roles of the PE and home office. The authorised approach would seem to clearly require the latter approach to be followed, although subject to comments about a quasi-thin capitalisation approach. (below).

***Other issues as identified within the body of the Report.***

Covered under paragraph numbers below, together with other comments.

Paragraph 2.

It is stated that “*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.*” It should be stated that this is by no means the only reason to prefer PEs. A regulator might even insist on a PE, or there might be a licensing advantage. There can also be many economies of scale in a PE, such as one Board.

Above all, for the purposes of this report, it may be possible to economise on surplus overall. This is recognised e.g. in the discussion of the Capital Allocation approach at 141 et seq. It is likely that total surplus needs will be lower, adding together all host and home requirements, than if all PEs became subsidiaries.

This must be the crucial question re the attribution of profits. There is a tendency of host tax authorities to require a PE to have the same assets attributed to it as would a similar subsidiary. This is what a “separate and distinct enterprise operating under the same or similar conditions” is often taken to mean. But this might well lead to each PE being attributed a level of surplus which, added together with that of the home country, considerably exceeds the total actually held by the legal entity. There might even be none left for the home country, or a negative amount.

To mitigate double taxation, this cannot be the right answer. It is essential that the Draft be amended to include a clear proscription of “more than 100%” attribution. This necessitates clear guidance on which will prevail, home or host attribution. As the total of host attributions might be “more than 100%” attribution, it would seem that the only practical answer must be home attribution to prevail.

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

It is a fundamental principle that this section should not appear in a “Discussion Draft of the Report on the Attribution of Profits to a Permanent Establishment”. Nothing so out-of-scope appears in Parts I, II or III. If the OECD wishes to consider the subject matter of this section, then it should clearly be done by a separate exercise.

We therefore do not comment in detail here on this section, other than to say that there are a number of unsubstantiated and unjustifiable statements made. For example, the second sentence of paragraph 66 states that “*A very large percentage of direct insurance is reinsured, and a very large percentage of reinsurance is reinsured once again (retro ceded)*” This begs the question of what is a “very large” percentage, but as stated this is surprising to the insurance industry. Then there is an almost grudging statement that related party reinsurance “can have non-tax motivation”. Any implication that usually it does have tax motivation should be removed.

#### ***Functional and Factual analysis***

##### **KERTs**

Para 75. et seq

Much of the public debate to date has revolved around the concept of KERTs. We are aware that the concept is being reconsidered by the OECD, and that is perhaps why there seems to be less emphasis in the Part IV draft than in other Parts. The concept might therefore be revised. Nonetheless, it would seem likely that some variation on KERTs will survive any revision, as any factual and functional analysis must be based on who does what and where, and the “what” would seem to include, if not consist solely of, taking important decisions about risk. Comments on KERTs therefore follow here.

We believe that the concept of Key Entrepreneurial Risk Taking Decisions as the basis of attribution should be changed.

The word “key” is a hostage to fortune. What makes a decision key, and another not? There is no definition in the draft. It must depend on the facts and circumstances of each enterprise, leading to some risk of circularity, as what is key for one PE might well not be for another. Even if it can be decided which decisions are key and which not, it might also be the case that several “non key” or “slightly less than key” decisions have more effect than one “key” or “slightly more than key” decision. Also, not taking decisions can have important consequences.

The word “entrepreneurial” would seem to be redundant, or at most it might serve to stress the emphasis on risk-taking. It is also arguable that it means taking risk at a “strategic” level, that of the owner, in setting up or continuing to run a business. The word “entrepreneurial” does not suggest “*...the taking on and day-to-day management of the individual risks and portfolios of risks....*” (para 75).

Risk reduction as well as “taking” is also important, e.g. via reinsurance. Perhaps we should focus on risk- management. We should use a concept of, say, risk-management functions, or “RMF”s, not KERTs. Compared with previous drafts, this would seem to be implicitly the direction Part IV is taking, e.g. in paragraph 75.

Discussion of draft Parts I, II and III has included criticism that there has been an overdue emphasis in identifying KERTs with the act of entering into contracts. There has arguably been an identification of KERTs with the act of legally taking on risk. We might describe it as a “point of sale” KERT. In Part IV there seems to be less of this emphasis , but still some emphasis on the KERTs being “... *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...*” (para 75). By contrast, the setting of the policies within which those actions take place seems to have less KERT emphasis.

We believe that an analysis of the insurance industry would reveal that often the exact opposite is the case. Entering into an insurance contract is very much the act by which risk is put on the company’s books from a narrow legal sense. However, this act is often very much an automatic implementation of a set of policies decided by others, at earlier times, and quite possibly in another country. Typically this will be home country setting the parameters within which host PEs can operate. Equally, the ongoing management of risks may well be in other hands, for a number of years after incurring the risk, and in another country.

This will also be the case in third party arrangements. In effect, an insurer is economically at risk from the moment that it decides to allow, for example, an “agent” to write an amount of business within given parameters. A large amount of insurance in the OECD is sold by independent agents. Clearly any KERTs undertaken by insurers in such cases are before and after the actual sale. A functional and factual analysis of a branch will often reveal a similar position.

Take the case of insurance purchased over the internet, a growing aspect of the industry in personal lines especially. Paragraph 82 of Part I makes it clear that “A server-PE will not be carrying out any key entrepreneurial risk-taking functions in the absence of personnel”. We agree (if the condition re personnel is deleted). The agreed implication is that the creation of an insurance contract, by internet, is not a KERT. We consider this to be the case not because a server is at work per se, but because the act of creating the risk in such a case is an automatic process. The real KERTs lay in setting up the server, and programming the insurer’s underwriting into it.

This means that exactly the same analysis, by analogy, must apply where people are involved, but following underwriting policy in exactly the same automatic way. Many insurers, especially on personal lines, sell exactly the same policies on exactly the same terms both via internet and via other means, such as call centres, or agents. The personnel involved are likely to have no more independence of underwriting policy than a server. The logical consequence of this analysis is that a PE could have a large number of staff selling insurance, and yet carry out no KERT, in exactly the same way as a server might. Indeed, insurance is often sold via internet or telephone, side by side, with the only difference being perhaps a small discount on premium for the internet route to reflect the cost saving. Other industries do the same, e.g. travel.

Once insurance risk is on board, the management of it will usually be handled by quite different people than those who incurred it. Fund managers, claims managers and reinsurance will come into play. Again, the insurer can pass these functions to others. Third party fund managers are common, third party claims managers increasingly so, and reinsurance can pass the risk to reinsurers. These functions, together with the setting of underwriting policies, will typically be the big KERTs in insurance. They may well be less typical of PEs than of the home office.

A further problem with an undue emphasis on “point of sale” is runoff business. All insurers invest a great deal of time and expense in managing their “in force” business. This can last for half a century re many lines, such as life, pensions, or liability insurance. In some cases insurers cease to write new business, but for perhaps 50 years they continue in “runoff” of their old business. Claims management, investment, and reinsurance can remain crucial activities long after premiums are no longer written.

The emphasis on “point of sale” risk-taking should therefore be reduced, and that on setting of underwriting guidelines increased. Equally the emphasis on “day-to-day” management should be reduced, and that of reviewing underwriting, reinsurance, claims and investment policies increased.

The points above are by no means a comprehensive analysis of the KERTs in insurance. They hopefully do demonstrate that insurance is sufficiently complex and with enough particular features to justify being discussed further before finalising Part IV.

### ***Recognition of dealings***

Para 86.

It is not correct to say that “*all parts of an insurance enterprise have the same creditworthiness...*” All parts may have the same credit rating, by virtue of all being part of one legal entity. However, it should be an inevitable consequence of hypothesising a PE as a distinct and separate enterprise that it should NOT be simply attributed the credit rating of the entity. It might well have a different creditworthiness. In fact, as size is taken into consideration when assessing creditworthiness, (on the basis that the bigger the enterprise the greater the spreading of risk), then only a PE which is the bulk of a legal entity is likely to have the same creditworthiness. A small PE would almost certainly have a lower creditworthiness. It might also need the whole of the entity’s surplus to get the same credit rating as a similar subsidiary – and so might each of several PEs, plus the home office.

It is also likely that the nature of a PE and of the rest of the entity might differ, as is recognised e.g. at paragraph 139, with possible differential effects on creditworthiness.

As to the second bullet, it must follow that there should be scope for internal guarantees between PE(s) and home office. Whilst such cannot be implemented

legally, they should be recognised for tax, on the distinct and separate enterprise hypothesis, to reach the correct TP result.

### ***Agency PEs***

Para 116 et seq

This paragraph seems to start well by saying that the current report does not stray into Article 5, and particularly that “.. *the discussion below is not predicated on any lowering of the threshold of what constitutes a PE under Article 5*”. Unfortunately it then goes on to state that “...*some of the functions associated with an insurance business are commonly undertaken by dependent agents....*” And even identifies “... *dedicated brokers...*” as “(*dependent agent enterprises*)”. Whereas, the term brokers is widely used in insurance, and signifies very much independent agents, as is suggested by Article 5 itself, where no PE arises “...*through a broker, general commission agent or any other agent of an independent status* “

There has been a lot of debate in recent years about the possibility of undeclared PEs. It is important to note that the extent of regulation in the insurance industry makes this very unlikely. There are very strict controls on how insurance is written, and by whom. If a host insurer were acting as a dependent agent for a home insurer, without this being declared to and authorised by the regulatory authorities, it is virtually certain that both companies would be committing criminal acts under the insurance legislation of both countries. This would typically have consequences not just for the entities but also for directors and other “approved persons”. Insurers and their agents therefore spend a great deal of time and cost ensuring that insurance regulations are followed. As the tax and regulatory rules are very similar, the risk of an “inadvertent” PE must be very low.

It is important to remove from the discussion of dependent agent PEs any Article 5 debate, and especially any implication that there may be many such PEs in the insurance industry. It should be sufficient, as the bulk of the section discusses, to state that attribution to a dependent agent PE and a branch PE will follow the same principles.

### ***Capital allocation.***

Para 141.

Whether the Capital Allocation Method is used or not, it must be a fundamental principle of the eventual guidelines that “... *the sum of the attributable surplus will be neither more nor less than the total surplus belonging to the business as a whole.*” It is worrying that in paragraph 141 this is stated to be one of the two principles underlying the capital allocation method. It should underlie any method used, and should be stated as a fundamental principle, in Part I.

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

It is essential that the eventual guidelines permit taxpayers, and tax authorities, to adopt some hybrid approach if particular facts and circumstances dictate. In practise, there will be an exception to any rule, and some flexibility is inevitable. For example.

Premiums. In addition to the caveats in the draft, this would not be a good option where an enterprise, or any substantial part of it, was in runoff, i.e. not writing any premiums.

Technical Reserves. Further points include that some reserves are discounted for future investment income, whilst some are not; and reserving can vary considerably over time, e.g. with evidence of average life spans, or court cases re liabilities. Attribution based on reserves can therefore lead to considerable variation from one year to another.

It should be noted that regulators often use hybrid approaches when calculating the need for assets/surplus. There may be a number of calculations based e.g. on claims, and premiums, whether overall or according to lines of business. This would suggest that any approach based on the regulatory position would have to countenance a hybrid approach.

Para 154.

Re the request for allocation keys, it would seem that the principal candidates are premiums and reserves, as discussed in the draft. Following from either are a number of issues of detail with potentially important consequences. For example,

Premiums - Written or Earned, Gross or Net?

Reserves – Discounted or Undiscounted, Gross or Net?

For either, accounting standards, or regulatory rules?

For either, whose figures, Home or Host(s)?

And no doubt many others, probably best discussed separately at a later stage.

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

This section seems to be redolent of the fundamental tension underlying this whole exercise, between “capital allocation” and the arm’s length principle as applied to a hypothesised separate and distinct enterprise PE. The latter inevitably tends to attribute surplus somewhat akin to a similar subsidiary, and so too much for any reasonable share of the surplus of the enterprise as a whole.

From the taxpayer’s viewpoint, the most straightforward way to ensure taxation of the entity’s profits once and only once would be for all tax returns to follow the accounts of the Home Office, including those parts covering PEs. These accounts would all have to be the Home country accounting standards and currency, in order for the combined accounts to add up to 100% of the entity’s profits. (PEs might well have host accounts with different accounting standards, in different currencies, written in different languages, etc. But each PE must have a home country accounting return following home country GAAP in order for the home country entity accounts to be properly drawn up.)

Such an approach would not be suitable to the eyes of fiscal authorities, at least in host countries, owing to such features as use of non-local accounting standards, and not necessarily being consistent with the arm's length principle. However, it should be noted that any step away from such an approach inevitably risks double taxation, or less than single taxation. Also, the problem of different accounting standards in principle should be reduced over time as accounting standards are increasingly harmonised.

The home regulatory return could also be used in this way, with PE returns under the home rules as the basis of PE taxation. Again, this would not be necessarily an arm's length approach.

As soon as we move away from this type of approach, there is a risk of double taxation. For example, use of host regulatory returns for quasi-thin cap does not have the merit of tending to produce taxation once and only once. Host regulators will almost certainly tend to insist on pulling into host countries, or at least host regulatory returns, more assets than a branch accounting return. This is because host regulators tend to push down asset valuations, push up liability valuations, and then insist on surplus on top. To add up all regulatory returns will therefore tend to produce more surplus than the entity has, as all the surplus will be in the home return, and some will also be in host returns. Then there may be a further tax attribution requirement on top, increasing still further the double taxation.

Whichever method or methods are eventually approved, the key points for business are that method(s) should be capable of relatively simple, certain application; produce no double taxation; and if there is to be more than one approved method, then a taxpayer should be able to choose any approved method without this being overturned by one or more fiscal authorities. If the latter is not acceptable to the OECD, then there really should be only one method.

***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.***

A quasi-thin capitalisation approach then adds a further element of double count to a hypothetical adding up of regulatory returns, insofar as it attributes any assets to host PEs above the levels already in host returns. In effect, it is a step along the independent enterprise approach and so into double taxation.

However, the quasi-thin capitalisation approach has a great deal of merit as a safe harbour. In practise, this is how many taxpayers and fiscal authorities have approached PE taxation. There is the comfort factor of being based on returns not produced for taxation purposes, audited and inspected by regulators, which treat PEs broadly the same as comparable companies. No matter what is decided, one suspects that many host tax authorities will wish to see host regulatory returns as some sort of check on host taxation.

Para 162.

On the other hand, as is stated, a quasi-thin capitalisation approach is not wholly consistent with the authorised approach. Nonetheless it should be allowed at least as a safe harbour.

This should be allowed all the more so because it is quite likely that a quasi-thin capitalisation approach will attribute MORE assets than would the authorised approach. The footnote suggests the opposite, because it is focussing on the step of attributing surplus, i.e. above a given local regulatory asset level. So thin cap or capital allocation might well attribute more than quasi-thin cap **in this step**. However, looking more fundamentally, a full factual and functional analysis might well reveal that a lot of business written by a PE, and so subject to the host regulatory return, is in fact to a greater or lesser extent really under the economic ownership of the home office. (e.g paragraphs 96 and 97). So the current authorised approach might well remove some of the apparent PE tax base per the host regulatory returns to be subject instead to home taxation. Whereas, a quasi-thin cap approach omits this vital first step analysis.

Also, as previously noted, regulatory returns tend to have reduced asset values, increased reserve values, and then require surplus on top.

There may be exceptions, but on the whole we would therefore expect quasi-thin cap to produce more host taxation than a full implementation of factual and functional analysis. This approach therefore should be an available safe harbour, with taxpayers able in effect to pay more tax for administrative simplicity and certainty. This is particularly the case as many insurance PEs are quite small, and so just paying some “excess” tax can be a sensible economic decision which many already make.

For the same reasons, we also would recommend that quasi-thin cap be made not just a safe harbour but an authorised approach. It has the merits of simplicity, independence (audited regulated non-tax returns), and probably yields mostly higher host taxation.

***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.***

The first issue is relatively straightforward. The investment management function consists of two aspects, “day to day” investment, and strategic direction on what assets to invest in, and how.

The former is the function of investing in assets according to guidelines, so for example deciding which equities to hold within guidelines on percentages or amounts to be invested in equities. This may be in-house or outsourced. If outsourced, cost is third party. If in-house, there are comparables in third party arrangements available to ensure arm’s length compensation.

Strategic direction of investment is not likely to be “day to day”, but for example quarterly reviews of markets, percentages of portfolios to be invested in equities/debt/properties, which countries/currencies, whether high income yield, and even who to

use as fund managers. This is very likely to be centralised at home office, and not to be outsourced. Costs arising are likely to lead to host costs under Article 7 para 3.

Determining the investment yield from a given level of surplus attributed is more difficult than the draft suggests.

The principal problem is that the rest of the insurer is unlikely to have any assets particularly suitable for attribution to the PE, which we are assuming here has been attributed under the authorised approach more assets than it actually has in its local books, or locally invested. This is because, given more assets, it is highly likely that the PE, on a separate enterprise approach, would have invested in assets which its home office, or fellow PEs, have not invested in. The PE would almost certainly have invested in host country assets, whereas home office probably has home country assets. Equally a very different view might have been taken of maturity, risk profiles, or currencies. It is even likely that a host regulatory return would have valued any home office assets, if transferred to the PE, at nil or reduced valuations.

Paragraphs 170 et seq are probably implying that identification of suitable home assets for host attribution is far more likely than will actually be the case. Typically a fungible approach to home assets will have to be taken, with none more or less attributable to a PE than another.

In either case, direct or indirect attribution, a host of other issues arise. Home assets will typically be in non-host currencies, accounted for under non-host accounting standards or regulatory rules, and probably written in another language. Strictly, the yield should be re-calculated under host GAAP, with foreign exchange translations. (and of course some home office accounting may already have been FX adjusted from a third currency).

This is an administrative nightmare for taxpayers. There should be a clear acceptance of home country accounting to calculate the yield for any attribution of home assets to host PEs.

There should also be a safe harbour yield of home assets on a fungible basis, if no direct attribution of some home assets more than others can be justified.

It should also be clearly stated that an attributed yield could be negative.

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

As discussed above, we have reservations about the KERT concept, but recognise that the eventual approach should focus on the management of risk.

It is absolutely clear in insurance that the act of entering into an insurance contract is just one aspect of risk management.

Beforehand, as discussed above, there are decisions about what lines of business to write, where, at what prices, by what means, and to which customers. At the extreme,

after all these KERTs, the actual entering into of a contract, and so risk, might be done by a website/server.

After the completion of contracts, risk management might well continue for some 50 years. Some insurance risk is settled quite quickly, on such “short tail” business as motor. Even so, there is continuing management of risk post contract, as the settlement of claims may still take 12-18 months. Ongoing management will need to focus on reinsurance, whereby risk can be passed to reinsurers; investment of the assets needed to pay eventual claims; and all other aspects of management, e.g. to avoid the risks of regulatory penalties or reputational damage from poor settlement of claims.

With long tail business, such as life insurance, pensions, liability, pollution, etc, the tail may well be up to 50 years. Over such a long period investment income is likely to exceed considerably both the premiums earned and any eventual claims. (Say 100 premium, less 20 expenses, leaving 80 invested for 50 years at 5 per cent would make 917, not 80, to pay eventual claims) Long tail business does tend to have large claims, for e.g. pensions, or at the end of long court proceedings re liability. Ongoing management of such risks, whether investment, claims settlement, or reinsurance, can arguably make the initial writing of insurance seem relatively unimportant.

Para 188.

The statement that “...*reinsurance essentially is the provision of capital from one entity to another*” should be changed. It is true that reinsurance might act as an economic alternative to raising more capital, but it is by no means an equivalent. There are many important respects in which the two differ.

If an insurer has more risk than its capital can bear, then it might reinsure to reduce the risks, rather than raise capital. Alternatively it might just write less insurance, although economically this would rarely make sense if reinsurance was available at a suitable price. But an insurer might reinsure for many other reasons, all of which are about passing on risk, and not necessarily about capital.

Insurers may reinsure even where not reinsuring would cause no need for further capital, but in order to manage the risks which they wish to retain. Equally insurers may reinsure even when no reduction of regulatory surplus requirement arises from the reinsurance. Regulators typically insist on surplus to cover 50% of insurance, even if more than 50% is reinsured. For example, some insurers reinsure virtually the whole of book, e.g. 98%, just because they do not want to retain more than 2% of risk, even though 50% of capital requirements will remain for their regulatory return.

It is also true that reinsurance and the raising of capital have quite different economic, legal, accounting, regulatory and even tax consequences.

Reinsurance therefore can provide flexible support which reduces the need for capital in certain circumstances, but any implication that reinsurance and capital-raising are equivalents should be avoided.

Para 190

It is very likely that the home office will have responsibility for ongoing management of a PE's risk, as this is an essential part of the entity risk. It is also likely that a small number of very senior staff carry out this function, although it is unlikely that a single person would do this without review.

***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.***

As a general principle, we believe that there should be no cross-references between Parts II, III and IV. This is because the industries are quite different, and any cross-reference risks being misleading. Most readers of one of these Parts will probably not have sufficient understanding of the other industry or Part to enable them to put any cross-reference into context.

On the other hand, there should of course be consistent and equitable treatment between all industries, including those covered by Parts II, III and IV. This should be achieved by ensuring that those Parts are consistent, and via Part I, but avoiding cross references other than to or from Part I.

It is also vital that all four Parts are finalised at the same time.

As to the substantive question, product development certainly occurs in insurance. Insurance policies vary considerably, and over time. There is a constant effort to refine and improve the products, and services to policyholders. Policies are likely to be standardised in personal lines, but very much individually structured for major corporate or government clients.

This activity might be at PE or home office level, and should be rewarded as per TP analysis.

***Regulatory Compliance – Views of Business are invited on this point.***

This point is another example of the inconsistencies inevitably engendered by treating a PE partly according to its “reality”, as a branch, and then partly as a hypothesised distinct and separate enterprise, or as a quasi subsidiary. The moment we begin to hypothesise, we come to results other than the realities.

On the one hand, the PE will always be regulated by the home country, as part of the legal entity. The extent to which the home regulator will focus on a PE in particular will depend on the home regulator's approach, and the size of a PE. Sometimes home regulation insists on a PE having “substance” in the host territory, sometimes the PE is just included in total entity figures. But the PE will always have to produce a PE return for its home office with figures suitable to include in the home office regulatory return.

On the other hand, as paragraph 226 says, a distinct and separate enterprise would not need this return. This extra requirement might be more or less onerous depending on the extent of adjustment needed from any host figures required. (language, accounting standards, regulatory rules, relative size, auditing requirements, regulatory audits?)

The only solution, as suggested, would seem to be to treat this compliance as a “same or similar condition”.

This issue affects not just any home office assistance costs, but also potentially PE costs locally incurred in complying.

The issue does not arise solely re regulatory returns, as PEs also have to produce home-country accounting returns for home entity accounts, and possibly other information. For example, a non-US PE of a US entity might have to deal with Sarbanes-Oxley.

#### ***ARTICLE 7(4) – IS IT UNNECESSARY***

We tend to agree that Article 7(4) will eventually prove to be unnecessary, once the authorised approach is fully in place. However, the process still has some time to elapse, and so we would recommend keeping this decision on hold until all four Parts, and the action plan for changes to Commentary, Model Convention etc are agreed. It may be that 7(4) might still be a welcome approximation in at least some circumstances.

#### ***F. ARTICLE 7(7) – CO-ORDINATION WITH ARTICLE 10(4) ETC***

The comments here should perhaps be in Part I, not IV, as other industries could be affected.

We agree with the analysis in this section. However, we would ask the OECD to reconsider the desirability of this result. In practise, we may be faced with attribution adjustments some years after the payment of interest and dividends. Under Articles 10 and 11, withholding tax levels may well have been decided on home office treaty levels, e.g nil on interest. When attribution to a PE arises, this may have to be changed to, say, 30%. This could have consequences for the payer, paying agent, and recipient. There might be penalties involved. Tax returns in both host and home countries might need to be changed, including claims for double tax relief. All this might take place years after the year(s) of payment.

The problems become even more acute where any adjustments are not of one particular asset, but of part(s) of assets, or even part of every single asset, as per the earlier discussion in these comments of how to attribute yield in the case of fungible assets.

It would seem that there is a strong case on the grounds of practicality to allow such “secondary” consequences of attribution to be ignored, at least where fungibility arises. On the other hand one can understand concern re possible abuse. Perhaps the best compromise would be adjustment of Article 10 or 11 only for direct attribution of particular assets that in some way were clearly owned by a PE. Whereas, in the case of indirect attribution, the suggested approach of accepting home country yield should be extended to accepting home country treatment for Articles 10 and 11.