

October 31, 2007

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REPORT ON THE ATTRIBUTION OF PROFITS TO A PERMANENT ESTABLISHMENT PART IV (INSURANCE)

Dear Jeffrey,

BIAC appreciates the significant changes the OECD has made in the revised draft of Part IV (“August 2007 draft”). We recognise that the changes made aim to reflect the concerns raised by the insurance industry with the prior draft, and as a result we believe the revised draft will be much easier to apply. This letter contains comments and recommendations to assist the OECD in bringing further improvements in the final version of Part IV. Our comments are limited to points specific to the insurance sector and do not address text in Part IV that is also found in the versions of Parts I-III issued in December 2006.

BIAC believes the August 2007 draft is far clearer than the 2006 version and more accurately reflects insurance sector practice. However, in the following areas we believe there is a need for further drafting improvements:

- Insurance risk assumption
- Investment assets
- Regulatory requirements and
- Internal reinsurance.

Insurance Risk Assumption: Key entrepreneurial risk taking function (“key function”)

BIAC welcomes the conclusion, following industry representations, that the principal key function in insurance transactions is assumption of insurance risk. However, we recommend that the key function should be described sufficiently broadly throughout the report to cover the various facts and circumstances that can arise in the various types of insurance business, if Part IV is to fairly address all insurance businesses within one Part.

In the August 2007 draft, performing the underwriting function is stated in paragraph 69 to be the key function for Part IV. Even though in paragraphs 34-37 the August 2007 draft attempts to widen “underwriting” beyond the common meaning of the word to cover comprehensively the spectrum of possible insurance risk assumption activities, it will always be problematic to use this word for something broader since “underwriting” will inevitably be linked to underwriters.

Instead, the approach of Paragraph 94 should be used. This paragraph focuses the key function of “assuming insurance risk” on the active decision-making functions relative thereto. This more

generally states the function than does the 'underwriting' term and emphasizes the importance of the facts and circumstances in the determination. As discussed in paragraphs 69 and 70, we support the position that in all circumstances the range of activities that make up insurance risk assumption must be analysed.

For example, under this facts and circumstances approach, risk management can be the insurance risk assumption. The fundamental nature of insurance is the ability to (strategically) pool a diverse range of risks, which is the essence of the risk management function.

Hence, we believe the function of assuming insurance risk can include persons working in underwriting, risk management and asset liability management ("ALM"), depending on the facts and circumstances. Therefore, throughout the document, we suggest deleting "underwriting function" and replacing it with "insurance risk assumption function", noting, as in paragraph 94, that such function could be any one of a broad spectrum of activities depending upon the type of business. The intent here is not to overly complicate the calculation, but instead insure that, given the complexity and breadth of the insurance business, the activities that contribute the most to the profitability of a PE are deemed to be the key function, which then determines "economic ownership" of assets and the attribution of profit.

To make the report consistent on this issue, BIAC recommends that certain amendments be made to paragraphs in Section B describing the industry, in order that the correct definition of the insurance risk assumption can be referred to later in the report. The title for Section B-2(c) should be changed to read "Insurance Risk Assumption Activities" and a separate title for Section B-2(d) should be removed so that paragraphs 38-41 may be considered part of Section B-2(c): Insurance Risk Assumption Activities.

Insurance risk assumption then appropriately includes not only underwriting, but also risk management activities. Thereafter, "insurance risk assumption" should be used in place of "underwriting" in most instances. The above implies that some further wordsmithing throughout the document will be required. For example, BIAC recommends that at paragraphs 8, 38 and 56, "underwriting risk" should be deleted and only "insurance risk" used. Other wording changes will be necessary in such paragraphs as 70, 191 and 192.

Similarly, we recommend that the ALM paragraph 44 be moved to form new paragraph 39 under "Risk management and reinsurance." Insurance risk assumption includes ALM, the purpose of which is to take on and manage risks (including timing of cash flows and matching of asset/liability durations) arising from accepting and investing monies. The risk assumed is to ensure returns are sufficient to back the commitments made under a relevant savings or investment based life insurance product. The personnel responsible for ALM may not be "underwriters," but they influence the setting of the price and dictate the range or volume of investment options available.

In summary, insurance risk assumption – the key function - is discussed many times throughout the report, but in slightly different ways that could lead to the erroneous conclusions that underwriting is the determinative activity and risk management is not important. We recommend that the changes described above are made so that the of insurance risk assumption is defined to generally encompass the following activities, the relevance of each in a transaction depending on the individual facts and circumstances:

- Setting the underwriting policy
- Risk selection
- Pricing
- Acceptance of insured risk
- Risk management
- Risk retention analysis (reinsurance policy, or retrocession policy for a reinsurer)

- Asset / Liability Management.

Consequently, BIAC disagrees with the language in paragraph 68 that states “the management of that risk subsequent to its assumption generally does not involve the kind of active decision-making that justifies treating that management function as a key entrepreneurial risk-taking function.” BIAC believes that facts and circumstances must be determinative. For example, for certain types of accumulation products, ALM involves highly active decision making during the lifetime of the policy. The profitability of the line of business is much more closely tied to the risk management subsequent to the assumption, than to the assumption itself. Similarly, where underwriting of a product may be done in a PE, that underwriting may be based on the assumption that the risk will immediately be pooled with other risks written by the enterprise for purposes of obtaining third party reinsurance. In this instance, the key function is the risk management/reinsurance decision, not the underwriting.

Investment Assets

A. All Remaining Assets

Paragraph 59 states that “[i]n the context of insurance, the capital required in excess of the other liabilities and reserves in order to assume the risks described above is commonly referred to as surplus.” Paragraph 74 states that “the amount of investment income includible in the (sic) taxable income arises from investment of assets representing both the reserves and surplus held by the company.” Consistent with these statements, step 1 of paragraph 90’s two step approach for the attribution of profits should state that the attribution of economic ownership of assets relating to non-insurance risk (“other assets”) should first be determined. Then, per Paragraph 73, “the economic ownership of tangible assets will be attributed to their place of use in the absence of circumstances in a particular case that warrant a different view.”

Finally, all other assets because they are either related to insurance activities or to surplus should be “investment assets.” This definition is important because assets supporting reserves and surplus include assets such as due and accrued premiums, reinsurance recoverables, other insurance related receivables and funds withheld.

B. Specifically Attributed Assets

A second issue relates to the allocation of investment assets specifically to an office of the enterprise. Investment assets held to back unit-linked policies (otherwise known as separate accounts or segregated funds) sold by either a PE or the Home Office are, although legally the company’s, specifically held to back the policyholder’s investment requirements under the policies and are legally not available to satisfy general creditor liabilities. As a result, even more than trusteed assets, such assets are already committed to a jurisdiction and should not be available for allocation. In these cases, we would suggest that such assets should be excluded from step one (page 29) and any further allocation requirement, as they can be easily linked to the respective jurisdiction’s reserve requirements. As a result, we would suggest the following alternative language be used for the last sentence of paragraph 142:

Where separate account assets (also called unit-linked, segregated fund etc. assets, depending on the jurisdiction) are not available to satisfy general creditor liabilities of the enterprise, and are specifically tied to separate account liabilities in a specific jurisdiction, such assets should not be included in the total investment assets to be allocated within the multinational enterprise.

Similarly, even if assets are not held in separate accounts, some products sold by insurance companies are so highly investment oriented that they may be considered closer in nature to investment contracts than insurance products for International Financial Reporting Standards

("IFRS") 4 purposes. The investment assets backing such an investment contract should be separately allocated to the respective office of the enterprise responsible for the contract.

C. Allocation methods and purpose

Paragraph 151 of the August 2007 draft specifically raises the issue of whether there is any key data that could be used to identify how to split asset allocations between business lines and locations. A number of data sources are already used in a number of countries, such as liabilities and reserves, premiums, and even expenses (in cases of run-off business). The issue for the industry is that the diversity of the business being carried out under the banner of insurance means that there is no simple single data source that would satisfy all requirements or lead to the best result in all cases. BIAC believes that the allocation key should rely on the facts and circumstances in each case,

D. Notional Attribution Only

Part IV indicates that one of the purposes of the functional and factual analysis is to determine the "economic ownership" of assets. Where the economic ownership differs from the jurisdictional (regulatory) ownership, a deemed attribution of assets will be made to determine the appropriate profit to attribute to a particular PE. However, because this attribution is notional, we request that clarifying language be put into the draft indicating that there is no intent that a deemed attribution to or from gives rise to any withholding tax, reduced tax benefits or taxable gain due to any change in the deemed owner of allocated assets. This is consistent with the statement in paragraph 137 that the capital allocation approach is not intended to identify specific assets to be attributed. We suggest that the following sentence be added at the end of paragraph 166:

Nevertheless, for greater certainty, the recognition of investment income on attributed assets is relevant only to the attribution of profits to the PE under Article 7 and does not carry wider implications as regards withholding taxes, which are outside the scope of this Report.

Regulatory requirements

The regulatory requirements of some nation states may be a strong factor in deciding where the profits of an enterprise should be allocated. This has been discussed in paragraphs 95-106 of the report.

The draft states that although the regulatory requirements may mean that capital must be maintained in a host state for risk liabilities that may occur for an insurance business, this necessity does not in itself mean that the activity must also be within that same host state.

BIAC welcomes the guidance stating that the nation state in which the assumption and management of insurance risk is undertaken is decided by the facts of the individual case. We agree that the regulations imposed by certain nation states are a factor in determining where the key function is undertaken, but should not in themselves be a determining factor.

We also generally agree with the guidance given in paragraph 105 that the financial accounting records should be respected as far as they are consistent with the functional and factual analysis to determine the location of the key function. We feel that more guidance may be needed, however, to decide what is meant by "a material amount." This is obviously not audit materiality, and the ambiguity in definition could lead to confusion or confrontation between taxpayers and tax authorities.

We appreciate the language in paragraph 166 that acknowledges that any assets attributed to a PE should earn a return closely associated with that earned on the assets held in the host jurisdiction. Regarding additional assets, while the bottom-up approach implicitly acknowledges

the regulatory constraints on the types of assets that can be held by the PE (as it uses a yield developed from the PE's assets subject to regulatory control), we would appreciate some mention of those regulatory constraints in the top-down approach as well. We suggest that the following be added at the end of paragraph 168:

In addition, regulators frequently restrict the type, quality and quantity of each type of asset that can be held by the PE, a factor which should also be taken into account in determining what assets and yield may be attributed to the PE.

Internal Reinsurance

Paragraphs 174-176 of the August 2007 draft recognize that internal reinsurance should be recognized when the key function is provided by the part of the enterprise providing the reinsurance. For greater clarity, additional text should be added. Possible language is: "Where the determinative activities of the insurance risk assumption in the reinsurance transaction are provided by the part of the enterprise providing the reinsurance, such a dealing must be recognized, assuming the other usual requirements for a dealing are satisfied."

Language Suggestions

BIAC believes that the definition of reserves used in paragraph 74 is far too restrictive, particularly in view of the clear intent of Part IV to align investment assets with reserves and surplus. The term "reserves" should cover any liability associated with insurance risk. This may include such other liabilities as claim reserves (not apparently covered under the above definition as they cover existing, not future, claims), reinsurance payables, policyholder dividend liabilities and the like. It is possible that the OECD intended such liabilities to be covered, in which case we would request that the paragraph 74 language be changed. A possible alternative is to define reserves as "all amounts considered necessary by the company's underwriter or actuary, taking all circumstances into account including solvency and prudent management requirements, to cover the insurance risks assumed."

As emphasized above, language must be approved regarding "insurance risk assumption" and "underwriting." Also, in paragraph 18, the first six words should be deleted.

We hope that most of the above points will be included in the agenda for 26 November. We look forward to attending and contributing to the session regarding these and any other points included in the agenda.

Yours sincerely,



Patrick Ellingsworth
Chair, BIAC Committee on Taxation and Fiscal Affairs