

Commentary

OECD report on Profits of Permanent Establishments of Insurance

Enterprises

AVIVA

Aviva is the holding company for the UK's largest insurance group of companies. Aviva operates in Europe, Asia, Australia, North America and the UK. In 2006 it had worldwide sales of £41.5bn and 59,000 employees serving 40m customers.

References are to paragraph numbers in the report. Aviva has commented only on those proposals relevant to large corporate taxpayers.

Executive Summary

1) Dependent Agent PEs

An explicit statement is required that the most common form of insurance PE, a dependent agent PE, is properly compensated by an arm's length commission where only sales of standardised products take place through the PE.

2) Capital allocation

A uniform basis of capital allocation is required. A method based on assumed uniform financial strength is suggested.

3) Identifying the KERT Function

For standardised products the key to profits (and therefore the key KERT function) is the design of the distribution system, not the underwriting function. This needs to be reflected in the report. Capital is needed to support the risks which attach to systems design.

Background

Aviva has over the period 1997 – 2007 pursued a policy of domesticating its larger life and general insurance branches and closing smaller branches to new business. ('Branches' are local offices in non head quarters countries providing insurance by Aviva personnel). The effect of this process has been to reduce its exposure to double taxation in the host country

and head quarters country and to give a clear management responsibility for its host country operations.

As a result Aviva's exposure to tax in respect of branch operations is small at present.

However there are still significant PE tax issues arising from the report:-

- 1) Aviva's UK headquartered life and general insurance companies have a large number of arrangements with independent multi national financial institutions (Business Partners) which permit those Business Partners to sell UK manufactured life and general insurance products from their premises in a number of host countries. The Business Partners undertake face to face sales in the host countries of a specified range of products to a specified class of potential customers.

In some cases the Business Partners will carry out claims management activities; in other cases claims management is done by Aviva or third party under a separate contract.

The financial arrangements with the Business Partners are on arm's lengths terms, being compensation paid to unconnected parties

In some cases the arrangements are such that the insurance contract is entered into at the point of sale under a 'freedom of establishment' licence in the host country by the authority of the Business Partner sales staff.

In such cases it is possible, though not clear, that a tax permanent establishment of the insurer may exist in the host state in terms of Article 5(5) of the OECD model treaty. Whilst it is not clear that the Business Partner's authority to issue contracts is the authority to 'conclude' contracts (since conclusion requires negotiation), or that the Business Partner is not an agent of 'independent status' acting in the ordinary course of their business in terms of Article 5(6), there is at least sufficient doubt for the matter to have been raised by tax authorities, and the following analysis refers to such Business Partners as 'dependent' agents. Where the 'dependent' agent PE function is restricted to selling a product designed in the headquarters jurisdiction on the basis of underwriting criteria set and maintained in the headquarters jurisdiction the functional analysis in our view gives the tax result that the PE activity is

adequately and completely rewarded by the arm's length rate sales commission paid to the 'dependent' agent.

Comment

1) Dependent Agent PEs

The analysis that third party 'dependent' agents are fully compensated by an arm's length commission payment appears to be supported by the commentary in paragraphs 116 – 119 which says;-

116. Where a dependent agent PE is found to exist under Article 5(5), the question arises as to how to attribute profits to the PE. The answer is to follow the same principles as used for other types of PEs for to do otherwise would be inconsistent with Article 7 and the arm's length principle. Under the first step of the authorised OECD approach a functional and factual analysis determines the functions undertaken by the dependent agent enterprise both on its own account and on behalf of the non-resident enterprise. On the one hand, the dependent agent enterprise will be rewarded for the services it provides to the non-resident enterprise (taking into accounts its assets and its risks, if any) usually by means of a fee from the non-resident enterprise.
117. On the other hand, the dependent agent PE will have attributed to it the assets and risks of the non-resident enterprise relating to the functions performed by the dependent agent enterprise on behalf of the non-resident enterprise, including a sufficient amount of investment assets to cover the reserves and surplus required to support risks. The authorised OECD approach then attributes profits to the dependent agent PE on the basis of those assets and risks. The analysis focuses on the nature of the functions carried out by the dependent agent on behalf of the non-resident enterprise and in particular whether it undertakes the key entrepreneurial risk-taking function. In this regard an analysis of the skills and expertise of the employees of the dependent agent enterprise is likely to be instructive, for example in determining whether underwriting or negotiating functions are being performed

by the dependent agent on behalf of the non-resident enterprise. The collection of premiums does not mean that the dependent agent PE is accepting the insured risk, if the risks associated with the insurance policy is not made by the dependent agent.

118. In calculating the profits attributable to the dependent agent PE, it would be necessary to determine and deduct an arm's length reward to the dependent agent enterprise for the services it provides to the non-resident enterprise (taking into account its assets and its risks, if any). Issues arise as to whether there would remain any profits to be attributed to the dependent agent PE after an arm's length reward has been given to the dependent agent enterprise. In accordance with the principles outlined above, the answer is that it depends on the precise facts and circumstances as revealed by the functional and factual analysis of the dependent agent and the non-resident enterprise. However, the authorised OECD approach recognises that it is possible in appropriate circumstances for such profits to be attributed to the dependent agent PE.
119. However, a functional and factual analysis of a transaction may show that the risks arising from the transaction are being assumed by the dependent agent enterprise for the account of its principal, i.e. the non resident enterprise in whose books the transaction – and the resultant risk – appears. These risks, and therefore the assets needed to support them, will be attributed to the dependent agent PE to the extent that resident enterprise. In short, when attributing profits to the dependent agent PE, there are likely to be profits (or losses) over and above the arm's length service fee paid to the dependent agent enterprise. This is particularly true in the case of insurance as the assumption of risk and the corresponding need to maintain both reserves and surplus to provide a cushion against the realisation of losses from those risks, is fundamental to the business.

It seems unlikely that the Business Partner who simply sells products manufactured elsewhere does undertake the KERT function in relation to those products, however it

would be in our view be helpful to say this in terms. We suggest a statement at the end of paragraph 119 saying:-

“However a pure sales function in respect of products designed elsewhere, in compliance with defined underwriting tables devised elsewhere, will be adequately rewarded by arm’s length sales commission, and there will in that case be no profits (or losses) over and above the arm’s length sales commission less properly attributable costs”.

2) Capital Allocation

It is possible that changes to the solvency rules for insurers may, in the future, make it advantageous to carry on business through a branch structure. If this is done, on the basis that the KERT activity takes place through the branch, it follows from the authorised OECD approach that investment assets will require to be attributed to the branch in accordance with the arm’s length principle, indeed the allocation of investment assets to the place where the KERT function is carried on could be seen as the key premise of the authorised OECD approach.

Against that background it is disappointing that the ‘Provisional conclusion for capital allocation approach’ is that “More thought needs to be given to methods of allocating the total investment assets as to approximate to an arm’s length approach”.

The OECD approach sets out to determine ‘the profits which the PE might be expected to make if it were a distinct and separate enterprise engaged in the same or similar activities under the same or similar conditions’ (emphasis added). It is described in paragraph 84 as a ‘basic principle’ that “all parts of an insurance enterprise have the same creditworthiness”. If this proposition is examined it will be concluded that the creditworthiness derives from the financial strength of the whole enterprise. This is because all the assets of the enterprise are in fact available to meet all its liabilities, and the brand of the whole enterprise also stands or falls by reference to all its activities. In order therefore for the various PEs to enjoy the creditworthiness of the whole enterprise it is necessary to assume, as a premise that “similar conditions” apply to all PEs, which is that all have the same brand and the

same financial strength. As stated at paragraph 132 “There is no reason to attribute part of the investment assets to the head office simply on the basis that the head office could be expected to absorb any extraordinary and unforeseeable losses arising from the risks”. For a similar reason there is in our view no basis for assuming the head office owns the brand, it is owned in fact by the enterprise as a whole, or to assume that the enterprise has branches of differing financial strength.

It follows that the capital strength of the company i.e. assets/regulatory liabilities and the brand should be the same in each PE. A uniform capital allocation approach should apply throughout based on a uniform, multiple of liabilities and no ‘charge’ for a brand should be assumed. Liabilities would need to be calculated on a common basis across the business. This approach is consistent with the premise that it is personnel activities which attract capital, not local rules; it would give one approach to capital allocation capable of uniform application. All PEs should be assumed to have similar percentage of surplus own liabilities. Contrary to what is said in paragraph 164 it is a weakness of the authorised OECD approach if resolution of issues by the Mutual Agreement Procedure is an in built feature of it.

The Mutual Agreement Procedure is not always an effective feature of co-operation or development for affected taxpayers. Disagreements can take years to settle, tying up capital and management resources in a wholly unproductive way.

3) Identifying the KERT Function

For certain standard types of insurance products, for instance term life policies, private motor and property general insurance, the product design and pricing is similar for most suppliers in a market. In the UK for instance, the proliferation of price and product comparison web sites has meant that pricing and product design for such products across most of the market is public information, which is for the most part generated and used electronically. A consequence of this development is that the “underwriting” of any given policy may not be the ‘Key Entrepreneurial Risk Taking Function’ (KERT), for such business the KERT is most probably the design, maintenance and development of the electronic system which provides information to the price comparison web site.

Similar issues arise in relation to business written through large financial institutions (the 'Business Partners' discussed above), typically creditor insurance sold by banks. The product design and pricing is relatively generic across most insurers. The function that "is most likely to affect most directly the profitability of the insurance enterprise "(i.e. is the KERT, paragraph 68) is in fact the activity by the managers, typically in the head quarters location, who negotiate the terms of trade with the financial institution. The key profit driver is the rate of commission paid, the structure and terms of the contract and the distribution activity it generates.

The point is that the 'assumption of insurance risk' is not always the KERT. Across swathes of high volume domestic business the KERT is the design of the marketing apparatus. This reality is recognised in paragraph 192 which says that "For very standardised products, for example travel insurance sold through vending machines in airports, the underwriting risk acceptance function is not undertaken by the vending machine but by the person who develops the product and set the insurance limits". Whilst the airport example may be correct, it understates the significance of system based sales for group insurers in the environment pertaining in 2007, and may not be correct. The key profit business for the insurer using the airport machine may be how much it pays the airport for the site, how prominent the machine is, and whether it is the only such machine at the airport. This is the case whether the precise sales function is carried on at the airport by a machine or a group of personnel.

For systems based sales the design of the sales system is actually the KERT .

This possibility needs to be recognised in the functional analysis. Sales of creditor insurance in the UK in 2005 were mostly through financial institutions and exceeded £4bn.

This is not a small matter and should be clearly provided for.

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