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Dear Mr Owens

**OECD REVISED DISCUSSION DRAFT - REPORT ON THE ATTRIBUTION OF PROFITS TO A PERMANENT ESTABLISHMENT PART IV (INSURANCE)**

PricewaterhouseCoopers ('PwC') welcomes the opportunity to comment on the revised discussion draft released on 22 August 2007. Our representations have been drawn up by a working party within PwC's global insurance and transfer pricing network.

PwC recognises the significant development in the clarity and coverage of the discussion draft, addressing many of the comments made by PwC and other industry & professional bodies following the release of the first draft in 2005.

Our comments focus on specific principles affecting the insurance industry for consideration in the further refinement of Part IV. We have not addressed aspects of the discussion draft which are derived from Parts I-III issued in December 2006.

**Determining the Key Entrepreneurial Risk Taking Function ('KERT')**

PwC welcomes the clear emphasis on a facts and circumstances based approach to the identification of the most important active decision-making functions relevant to the assumption of insurance risk. However, the definitions and terminology used in the discussion draft would benefit from further refinement to ensure consistency of interpretation and application across a wide spectrum of insurance products.

In particular, the discussion draft contains a number of variations on the definition of the KERT function as well as, at times, the interchangeable use of the term 'underwriting' for the assumption of insurance risk. To illustrate this point, we have included some examples below (bold type reflects PwC emphasis):

"the **assumption of insurance risk** is the key entrepreneurial risk-taking function for an insurance enterprise" – paragraph 68

"an insurance business will have one key entrepreneurial risk-taking function, the **assumption of insurance risk** by performing the **underwriting function**" – paragraph 69

“Once the location performing the **underwriting function** has been determined and the respective insurance risk has been attributed to it, it will be necessary to attribute an appropriate amount of assets to that location to back that risk” – paragraph 71

“In determining which functions within a particular insurance enterprise are the functions that make up the key entrepreneurial risk-taking function of assuming insurance risk, it is important to identify those activities that constitute **the most important active decision-making functions relevant to the assumption of insurance risk**. As a general matter, the relevant activities are those, typically falling within the category of **underwriting** activities described at Section B-2(i)(c) above, which are most important to the decision to accept a particular insured risk. Depending on particular circumstances, however, functions that are generally viewed as ancillary to the function of underwriting insured risks (e.g. product development, sales and marketing, and risk management) may themselves represent **active decision-making functions relevant to the assumption of insurance risk** – paragraph 94

“As noted in Section B-2(i), the **underwriting** function is a key component of the acceptance of insured risk and the consequential requirement for assets (surplus and reserves) supporting the insured risks. The **underwriting** function is therefore crucial to the insurance business in that it is a prime determinant of whether risk is assumed at all by the enterprise and of the price at which it is assumed. Accordingly, the part of the enterprise that is determined to have performed the **underwriting** function is to be treated in the first instance as the “economic owner” of the insurance policy and so is entitled to the associated underwriting and investment income.” – paragraph 191

“Exactly what functions have to be performed to amount to the performance of the **underwriting/risk acceptance** function will depend on the particular facts and circumstances and may vary based on, for example, the products, type of business and manner of distribution.” – paragraph 192

In order to promote a consistent interpretation of the KERT principle at the same time as ensuring that the concept can be applied across the full range of insurance products, we would recommend eliminating the use of the term “underwriting” as a proxy for the “most important active decision-making function relevant to the assumption of insurance risk” (paragraph 94) which we consider to be a clearer and more robust definition. The determination of the insurance KERT function would then be based on a facts and circumstances approach to the relative contribution of ALL active decision making functions relevant to the assumption of insurance risk.

One additional point relates to the definition of a KERT in Part IV relative to Parts II and III. Part IV states that within an insurance context, there is only one KERT, and that is the *acceptance* of insurance risk. Part IV clearly states that management of the risk subsequent to its acceptance is not normally a KERT. In contrast, Parts II and III state that KERTS in the banking and global dealing contexts will generally be the *risk acceptance and risk management* functions. This inconsistency is potentially troublesome in the case where essentially the same risk can be transferred in virtually the same way through either a derivative (covered in Part II) or an insurance contract (covered in Part IV). An example could be the transfer of the same credit default risk on a bond through a credit default swap versus a financial guarantee insurance contract. Although the same risk can be transferred through either instrument in essentially the same form requiring the same functions to accept and manage it, if a credit default swap is used then risk management subsequent to entering into the swap may be a KERT, while risk management of the insurance policy subsequent to issuance would not be a KERT. Thus, a different allocation of the capital supporting the risk may result from the same risk being transferred through a credit default swap as through a financial guarantee insurance policy. Good tax policy should achieve the same result when the same risk and functions are involved, regardless of the form of the transaction.

## Internal Reinsurance

Paragraphs 174 to 176 recognise the validity of internal reinsurance to the extent that the reinsurance KERT function is undertaken in the part of the enterprise accepting the reinsurance risk. However, the negative language of paragraph 176, along with the assertions contained in paragraph 177, have been interpreted by many readers as implying that internal reinsurance arrangements are likely to be disregarded as internal dealings and recategorised as risk management services.

Greater clarity would be achieved through the use of similar language to that adopted in Parts I-III. For example, paragraph 177 might be rephrased as follows:

*In considering the recognition of internal reinsurance, the critical question is whether this dealing simply recognises the performance of a risk management service, or whether the dealing should also involve the recognition of a transfer of the risks being managed, i.e. that the reinsurance location has accepted and assumed those risks.*

*In general, the risk management function of deciding whether to reinsure contracts held by an enterprise performed after insured risks have been assumed (with or without initial internal reinsurance) does not involve sufficiently active decision-making to be regarded as a key entrepreneurial risk-taking function. Thus, performing such a risk management function generally would not cause economic ownership of insurance contracts or the associated insurance risk to be transferred to the location where the risk management function occurs. Instead, performance of this function would give rise to recognition of a dealing in the nature of a provision of services that should be compensated by an arm's length fee, which in some cases may be based on the profits earned by the contracts.*

*However, provided the part of the enterprise providing the reinsurance has performed the key entrepreneurial risk taking function associated with the assumption of the reinsurance risk, this should lead to the recognition of a dealing that actually transfers the risks being managed so that they are assumed and borne by the reinsurance location. This will be determined on a case-by-case basis following the functional and factual analysis*

We would very much appreciate the opportunity to participate in the consultation meeting on 26 November in order to contribute to discussions on these and other issues on the agenda.

Yours sincerely  
on behalf of the PricewaterhouseCoopers Insurance Tax/TP Network

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