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Dear Jeffrey

**REPORT ON THE ATTRIBUTION OF PROFITS TO PERMANENT ESTABLISHMENTS PART IV (INSURANCE)**

KPMG welcomes the opportunity to respond to the revised public discussion draft issued on 22 August 2007. The revised draft is a significant improvement on earlier texts and addresses many of the concerns raised by the industry in previous consultations.

This letter sets out our comments on certain key areas of the discussion draft which we believe would lend greater clarity to the analysis and facilitate the application of the principles of the report to the wide range of different circumstances encountered within the insurance industry.

**KERTS**

KERTs are fundamental to the Authorised Approach, and we believe that Parts II, III and IV should, to the extent possible, adopt a consistent application of the Authorised Approach to the different financial services considered.

Part II of the report considers separately the functions involved in creating a new financial asset (a loan), and the functions involved in managing an existing financial asset. Having identified a number of different functions involved in each of these distinct processes, it then identifies which function is most likely to be the KERT involved in the creation of a loan and which function is most likely to be the KERT involved in the ongoing management of a loan. The analysis applicable to global trading in Part III is more complex, but maintains the distinction between the assumption and the ongoing management of risk. In the case of insurance, it may be that the ongoing management of risk is not represented by a function which is sufficiently active to represent a KERT in every case. However, we believe the report should recognise the possibility that ongoing risk management could involve the performance of a KERT, and that this should be determined on the facts and circumstances of the case. This is the approach recommended, for example, at paragraph 180 of Part II.

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In assessing whether a risk management function involves sufficiently active decision-making to represent a KERT, it should be recognised that the long-term nature of insurance means risk can be managed actively without the need for decisions to be made with the same degree of frequency as in banking or global trading. We believe that the requirement for a KERT to involve active decision-making is to distinguish such functions from purely strategic roles or those which are limited to parameter-setting.

If the report maintains its current stance, that insurance involves the performance of only one KERT then this KERT should be broadly defined so as to encompass the ongoing management of risk and should not be confined to activities surrounding the inception of a policy. For example, the decision to reinsure all or part of a risk is an essential part of the business of insurance. However, while this decision may form part of the creation of a policy, the level of risk retained may well be revisited at a later time, particularly when the “tail” extends over a number of years. Furthermore, an insurer can manage risk by entering into treaty reinsurance agreements at the beginning of a year which cover liabilities arising from policies written later in the same period, thereby managing risk before the inception of a specific policy.

Finally, we would note that for certain life products, the key entrepreneurial risk may not be insurance risk but market risk in respect of the investment of the premiums, for example in the case of annuities, unit-linked and savings products. This should be recognised by the report if Part IV is to address life insurance. The KERTs for such products might reasonably be determined by analogy with the analysis in Part II, and would include ongoing risk management.

### **Reinsurance between associated enterprises**

We welcome the proper restriction of Part IV to the attribution of profits to permanent establishments. We also welcome the recognition in the functional analysis of the role of reinsurance in freeing up surplus for the cedant, which is fundamental to understanding the role of reinsurance between separate entities.

### **Internal reinsurance**

Reinsurance between one permanent establishment of an enterprise and another is addressed by the discussion draft in the context of the conclusion that the management of risk in insurance does not involve sufficiently active decision-making to be considered a KERT. As noted above, we believe that the determination of which functions should be regarded as a KERT in respect of ongoing risk management in a particular insurance business is a matter to be evaluated by reference to the facts and circumstances of the case. We therefore believe that in order to maintain consistency in the application of the Authorised Approach across the different financial industries described in Parts II to IV, the recognition of internal reinsurance should be determined on a case-by-case basis and not rejected outright in all circumstances.

In fact, the wording of paragraph 177 currently suggests that the drafters did not intend to rule out the possibility of recognising internal reinsurance, since the analysis is tempered by the

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words “In general” and “generally”. This implies that in fact such dealings may in some cases be recognised. We believe that this is an area of considerable importance within the industry and that the drafting could lead to confusion. It would therefore be preferable in our view to state explicitly that, while such dealings will not be recognised as KERTs where they do not involve sufficiently active decision-making, this will depend on the facts and circumstances of the case.

An important issue for many insurers arises where third-party reinsurance is purchased at the level of the legal entity in respect of risks assumed in its different PEs. If the decision to enter into the third-party reinsurance is treated as a KERT, the risks of the PEs would be transferred to the PE in which the decision was made; if this decision is treated as part of a service provided to the PE’s in which the business originated, and not a KERT, the risks would remain in the PEs. In both cases it will be necessary to consider how to attribute reinsurance premiums and claims. In the case of quota share reinsurance in particular it will be necessary to consider also the attribution of ceding commission from the reinsurer, part or all of which may represent profit commission based on the profitability of the aggregate of the business ceded, when individual branches may have written business with differing levels of profitability. In the case of non-proportional reinsurance, the attachment point and upper limit of the treaty will be based on the aggregate position of the enterprise and issues may arise in attributing claims to individual branches. This is an area we believe deserves further analysis and discussion in the report.

#### **Attribution of investment income**

In determining the income to be attributed to a PE in respect of assets held to back insurance reserves and surplus, it should be recognised explicitly that in some cases reserves and surplus are represented by assets which do not give rise to income, for example property held in the long-term fund of a life insurer and occupied by the insurer itself or receivables under reinsurance arrangements. In the absence of such clarification we believe there may be a significant risk of double taxation where income-bearing assets are held outside the PE and taxed accordingly, and further income-bearing assets are imputed notionally to the PE to match its reserves and surplus.

We should be grateful for an opportunity to attend the public consultation on Monday 26 November 2007. We propose that Erica Howard and Robin Saunders attend on our behalf; contact details are:

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Yours sincerely

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