

October 30, 2007

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Dear Mr. Owens:

This letter is in response to the OECD's release of REPORT ON THE ATTRIBUTION OF PROFITS TO A PERMANENT ESTABLISHMENT PART IV (INSURANCE) Revised public discussion draft dated August 22, 2007 which requested comments from interested parties.

The comments are from tax professionals who practice in Ernst & Young's global financial services transfer pricing practice in the United States. These comments represent the consensus opinion of the undersigned but do not necessarily represent the opinions of Ernst & Young, its affiliates, or any of its clients.

If you have any comments or questions about our response, please feel free to call or email any of the undersigned. We appreciate the opportunity to provide feedback to the OECD and look forward to the opportunity to do so again on this important topic.

Sincerely,

Chris Faiferlick, Ph.D. (Ernst & Young LLP - United States)
Robert E. Ackerman (Ernst & Young LLP- United States)

General Comments

Reiterate the importance of a single-based taxation

The success of the application of the forthcoming and final Guidelines on the Attribution of Profits to a Permanent Establishment of a Multinational Insurance Enterprise (“Insurance PE Profit Attribution Guidelines”) will depend on the ability of the various tax administrations to apply these in a consistent matter. In particular, the mechanism to allocate to investment earning assets will be a significant aspect of avoiding double taxation for MNEs engaged in global insurance.

We are pleased by the improvement in the Draft’s view that double taxation should not result from an allocation of investment assets greater than those actually possessed by the whole enterprise. We are disappointed that more guidance cannot be provided to ensure that tax administrations have a means to reconcile differences in how investment assets may be allocated.

Assumption of Insurance Risk

The assumption of insurance risk may be a functional activity which cannot be defined simply as the acceptance of an insurance risk by an employee located within the PE jurisdiction. Risk analytics developed or intended risk management activities outside of the PE may be more critical to the profitability of the assumption of the insurance risk than the actual underwriting event.

We welcome the facts and circumstances approach stated in the Draft and agree that the example related to travel insurance in Paragraph 192. We appreciate that a split of the underwriting function may be possible between the PE and another location within the business enterprise (Paragraph 107). However, we believe unnecessary debate about what is broadly included within the term of “underwriting” will ensue. We believe that a facts and circumstances analysis as to what a KERT function is as allowed in Parts II and III would still be the better approach.

Underwriting

We agree that underwriting risk “is the process of selecting and pricing the insured risks to be accepted.”¹ The evolution of the insurance and reinsurance industries has resulted in policy pricing often being the most important aspect to long-term profitability. For example, in the P&C sector, underwriting models that more accurately calculate the replacement cost of a building lead to more accurate pricing of an assumed insurance risk. This pricing can make the difference between profit and loss on a sustained portfolio basis. In many instances such underwriting models are developed in the head office. Under such circumstances, we believe it may be more appropriate to deem the KERT function to occur in the head office and not the location of the PE. We think the current draft generally recognizes the potential for this and similar situations as illustrated in

¹ Par. 34 of the Revised Draft.

Paragraph 192 with regard to travel insurance and Paragraph 206 regarding the structuring of complex insurance products.

We think the term “underwriting” should be broadly defined and that under the authorised OECD approach, it is possible for the KERT activity to occur outside of the jurisdiction where the insured is located consistent with the recognition of split underwriting functions. As described in paragraph 69, the terms under which to accept an insurance risk is critically important and is a KERT function; however such acceptance is not solely limited to signing a policy with an insured.

We agree that an underwriting function can be split across jurisdictions under the facts and circumstances of a particular insurance industry.

Specific Comments

Par. 3. While this Draft is not intended to discuss what activities constitute a PE, a PE should not be deemed to arise solely because of an insured’s ability to access an insurance company’s website and engage in commercial activity.

Par. 4. While we think Section B provides a reasonable overview of the insurance industry, there are many variations within the insurance industry which may not be adequately covered by the discussion. In particular, evolving risk management techniques continue to add value to an insurance company’s business and may be more important to the long term profitability of the insurance company as opposed to routine underwriting activities.

Par. 8. It should be noted that the pricing of insurance risk is subject to cyclical effects which is referred to as a “soft” market for situations where an insurance company may not be able to charge as high a premium necessary to cover the insurance risk and a “hard” market where an insurance company may charge prices that provide a fair return for risk bearing.

Par. 9. Financial insurance is another type of insurance and includes business interruption insurance and some forms of guarantees. The principles of the Insurance PE Profit Attribution Guidelines should apply to these situations as well under the proper facts and circumstances.

Par. 16. An additional reference should be included regarding the influence that credit rating agencies have on insurance companies that seek to obtain a particular credit rating for a subsidiary of the group.

Par. 34. We think that “underwriting” is a multifaceted function where the underwriting KERT activity may be deemed to occur outside of the PE where the insured is located. We believe such possibility should be left open under a facts and circumstances analysis. We welcome the recognition of a split underwriting function as discussed in paragraphs 94 and 107 and believe this is appropriate under a facts and circumstances basis.

However, the “acceptance of insured risk” may be too narrowly labeled for purposes of the authorised OECD approach. The other factors listed in paragraph 34 are critical aspects of the “acceptance of insured risk” and failure to meet one of these elements, e.g., pricing per internally developed actuarial models, would not lead to the assumption of insurance risk. We think such functions may be part of the split underwriting function and thus we believe that this paragraph should not be so narrowly written.

As appropriately stated in Par. 35, “[t]he objective of underwriting is not the selection of insured risks that will not generate losses but to avoid the misclassification of insured risks according to the pricing of insurance contracts.” The efforts to avoid misclassification will often occur outside the location of the PE and will be critical to long-term profitability. Under such circumstances, the KERT activity should relate to the efforts to avoid misclassification as well and thus should be included as part of the split underwriting function.

Par. 40. We suggest that reinsurance to a related party serves the same purpose as reinsurance to third parties. We request such an addition to the final guidelines.

Par. 51. We are concerned with the importance that should be attributed to “financial assets.” We believe that other assets such as underwriting processes, brand, risk management policies, and similar items are what distinguish one insurance company from another and have a significant effect on profitability.

Par. 52. While we agree with the place of use test for attribution of tangible assets under the authorised OECD approach, we think two issues should be addressed. First, the use of tangible assets should generally be limited to a routine return and thus not be critical to the application of the authorised OECD approach. Second, the place of use test seems to undercut the OECD’s facts and circumstances analysis with regard to virtual underwriting activities. The OECD may wish to clarify whether place of use depends on the location of the potential customer, the head office that developed the virtual capabilities, or neither.

Par. 59. While we certainly agree capital is necessary to run an insurance business, we think an insurance company’s management of its credit rating is similarly important. The manner in which risk is managed can affect the credit rating that can be achieved from a certain amount of capital.

Par. 71. We agree that some functions within an insurance company may be very valuable and not directly related to the assumption of risk. We further agree in such circumstances that a residual profit split may be appropriate under the facts and circumstances. We wish to confirm that under the authorised OECD approach such a transfer pricing model effectively reallocates investment income from investment assets allocated to the insurance risk accepting function (KERT function) to the other residual profit generating activity.

Par. 83. In allocating investment assets, an appropriate method should avoid double taxation. No method that allocates more investment assets than exists within the MNE should be considered arm's length for purposes of applying the authorised OECD approach. In this regard, a proportional allocation of investment assets that leads to a total application of actual investment assets within the MNE should be considered meeting the requirements of the authorised OECD approach. Thus we agree with the allocation of all investment assets, no more and no less, to the various parts of the business described in paragraphs 131 and 134.

Par. 87. We respectfully disagree with the change in definition of the arm's length principle alluded to in this paragraph. The arm's length principle is defined in Par. 6 of Transfer Pricing Guidelines as:

In order to apply the separate entity approach to intra-group transactions, individual group members must be taxed on the basis that they act at arm's length in their dealings with each other. However, the relationship among members of an MNE group may permit the group members to establish special conditions in their intra-group relations that differ from those that would have been established had the group members been acting as independent enterprises operating in open markets.

Thus the language in paragraph 87 which defines the arm's length principle should be changed from its current version which states:

the arrangements documented in relation to the dealing, viewed in their entirety, do not differ from those which **would have been** adopted by comparable independent enterprises behaving in a commercially rational manner or the structure as presented in the taxpayer's documentation does not practically impede the tax administration from determining an appropriate transfer price; (emphasis added)

to language consistent with the paragraph 6 of the current Transfer Pricing Guidelines.

Par. 151. We believe a facts and circumstances analysis should be allowed to allocate investment assets. We agree that allocating investment assets among various business lines based on premiums would not properly account for the differences in risk bearing among these business lines.

One scenario is to use internal management calculations of return on equity (ROE). Management may have need to calculate a ROE by business line in order to optimize its allocation of group-wide capital. To the extent such capital allocation models are prepared, this information could be used to allocate investment assets. There are various models available to determine such capital allocations including marginal capital analyses. We include a copy of "A Survey of Capital Allocation Methods with Commentary, Topic 3: Risk Control," by Gary G Venter.² There are similar articles and models in the

² Available at www.actuaries.org/ASTIN/Colloquia/Berlin/Venter2.pdf.

economic literature. Ideally, the OECD would endorse a capital allocation model that is consistent with how the whole business allocates capital to manage its business and would leverage analysis performed by the company for non-tax business purposes.

If you have any comments or questions about our response, please feel free to call or email any of the undersigned.

We appreciate the opportunity to provide feedback to the OECD and look forward to the opportunity to discuss our response on the conference to be held on 27 November 2007.

Yours sincerely,

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