

Jeffrey Owens
Director, Centre for Tax Policy & Administration
OECD
2, Rue Andre Pascal
75775 Paris
France

Direct: 020 7303 2509
Direct fax: 020 7007 0179
dclissitt@deloitte.co.uk

Direct: 020 7007 3750
Direct fax: 020 7007 4075
ghillman@deloitte.co.uk

31 October 2007

Dear Jeffrey,

Report on the Attribution of Profits to Permanent Establishments – Part IV Insurance (“the Report”)

We welcome the revised version of Part IV of the Report issued in August of this year. It is a much improved document and we note that it reflects many of the proposed revisions to the original draft suggested by commentators from industry and the professions.

We would, however, like to take this opportunity to comment on the revised draft and suggest areas for further improvement and clarification.

Key Entrepreneurial Risk Taking Functions (“KERTs”)

The Report concludes that in the insurance industry there is only one KERT – that of “the assumption of insurance risk by performing the underwriting function” (paragraphs 68 and 69). It rejects the view that this KERT function includes risk management activity subsequent to the assumption of the insurance risk (paragraph 68). Similarly, the report rejects the view that this KERT function includes, generally, setting underwriting parameters where there is no further involvement in assuming or managing the risk (paragraph 70), although it does accept that there may be exceptions to this if warranted by the facts.

While in our view there are arguments for suggesting that there may be more than one KERT in the insurance business, we appreciate that having only one KERT may have the advantage of simplicity. That said, we feel that, whether there is one KERT or two, the approach adopted by the revised draft Report is too narrow in concentrating on the underwriting function alone as being solely responsible for the assumption of insurance risk.

In particular we would suggest that the risk management function is a critical one in the assumption and on-going management of insurance risk, and that this can apply both to risk management functions that take place before the assumption of the risks (for example, putting in place a reinsurance programme in advance of accepting risks) and to those that take place after the risks are assumed. We believe that the suggestion in the Report that the risk management function should not be included as a general rule as part of the KERT may be based on a false comparison between the insurance sector and the banking and financial trading sector – in particular the trading of financial instruments. While risk management in the insurance sector is not normally such a “busy” activity with the daily interventions characteristic of global trading, it is critical to the whole process of assuming insurance risk and managing that insurance risk, and daily activity should not be a prerequisite for a function to be recognised as a key one. It can also be remarked that risk management in the insurance sector is less “busy” than in financial trading because insurance itself generally entails longer term risk, which itself requires longer term management.

The recognition of risk management activity also needs to be sufficiently broad: as well as managing risk through reinsurance programmes, insurers – and particularly those with long term life, pensions or property and casualty business – pay particular attention to managing assets and liabilities (ALM). The ALM function is critical to the long term result of the entity in many cases through the decisions that it takes to manage the risk and liabilities of the enterprise. In some business types (e.g. “Zombie” fund consolidators) sophisticated ALM techniques are central to the business model and generate most of the value.

In our view the Report should more clearly acknowledge that risk management functions outside the description given of the “underwriting” process (in paragraphs 34 - 37) can be KERT functions, both when they are carried out before the insurance risk assumption and when they are carried out afterwards.

Non KERT PEs

Due to a combination of domestic law and the wording of particular bilateral treaties, a PE of an insurance company can exist in some jurisdictions where the functions performed are clearly not KERT functions. The collection of premiums is one typical example. Although we believe that the current draft of the Report does not require an insurance-specific methodology for calculating the PE profits in these circumstances (entailing attribution of the insurance result and associated investment return) we think that it would be useful to have some wording in Part IV of the Report which makes it clear that in these circumstance it would be appropriate to use another method of determining profits, such as cost plus.

Attribution of Investment Assets and Investment Income

General

This area of the Report is the one where we see the greatest potential for double taxation and the need for most work. This is clearly a difficult area and one in which there will always be scope for honest disagreement between taxpayers and tax authorities, and indeed between different tax authorities. For these reasons the Mutual Agreement Procedure (“MAP”) will always need to be

there as a fall back to help resolve such disputes. In our view the Report needs to go further in setting out a framework to minimise such disputes. We believe that there are several possible approaches that would help to achieve this goal:

(i) A single approach to allocating investment assets to a PE

If an enterprise were able to choose to adopt one approach to allocate its investment assets to its PEs, that should eliminate the possibility of double taxation arising through the use of different methods. While we appreciate that this would be a departure from the approach taken in other parts of the Report we think it merits further consideration as a practical means of resolving the issue.

(ii) Priority to the Home as opposed to Host country approach

One way of achieving a single approach to the attribution of investment assets would be to provide that the Host country will permit the use of the Home country methodology provided that that approach is permitted by the Report and used globally. Acknowledging this principle rather than giving priority to the Host country would eliminate much of the danger of double taxation that still exists.

Giving priority to the Host country means that the taxpayer runs the risk of multiple disputes in multiple locations over the basic approach, the allocation key used and indeed the calculation of investment income despite the fact it has followed an approach permitted by the Report. Giving priority to the Home country would immediately eliminate many of these risks. In our experience, most of the disputes that currently arise, arise for this reason with the taxpayer caught between the Scylla of its Host tax authority which argues that one approach is required and is the only true expression of the arm's length principle in these particular circumstances and the Charybdis of its Home authority which advocates an alternative, but equally authorised position of its own.

We appreciate that, given this approach has not been possible to achieve for banks, it may prove politically impossible to implement it for insurance companies. However, we feel obliged to raise it again as meriting further consideration as, in our view, it is the best way to minimise the risk of double taxation.

(iii) Insurers headquartered in territorial or exemption jurisdictions

Given that this area is of critical importance to insurance companies, the current draft wording in the revised Commentary which, in relation to the attribution of capital to bank PEs, places a requirement on the Home country to grant tax relief at the Home country level where the Host country has followed an acceptable approach in the Report, should be extended to insurance companies. Additionally, the wording should be clarified to make clear how an insurance company headquartered in a country that operates a territorial or exemption system of taxation can take advantage of this concession.

Attribution of assets

It would be useful to note that not all an insurer's assets are income producing. As just one example, reinsurance receivables are not. The allocation of assets to different parts of the enterprise should recognise the different nature of assets, according to the relevant facts and circumstances.

Trusted Assets

The topic of trusted assets is dealt with at some length in the Report. We have a concern that relates to the circumstance discussed in Paragraph 141 – namely where the trusted assets in a particular jurisdiction exceed the investment assets that would be allocated to that jurisdiction under the capital allocation approach. The final sentence of Paragraph 141 states:

“Where, however,... trusted assets in the PE jurisdiction exceed the investment assets that would be attributed to the PE under the capital allocation approach...an appropriate arm's length result would be to attribute those trusted assets to the PE, as they reflect the amount of assets the PE would be required to hold if it were a distinct and separate enterprise”.

We think it would be helpful to expand this discussion to give explicit recognition that, although trusted assets may be prima facie allocated to one part of an enterprise, it does not necessarily follow that all the investment return should be allocated to that same part. A split allocation would, for example, be appropriate where some of the KERT function is carried out by another part of the enterprise (for example, where business is underwritten through binding authorities with some of the underwriting functions taking place in another part of the enterprise).

It is worth noting that not all trusted assets should necessarily be attributed to the PE. We also believe that there should be recognition in the Report that an insurer may choose to have trusted assets within a jurisdiction that are above the regulatory minimum that it needs to hold in trust. As it stands, the last sentence of paragraph 141 could be taken as implying that all trusted assets are required to be held in trust, which may not be the case.

The approach of attributing trusted assets to a PE could over-reward jurisdictions with specific regulatory rules, and lead to double taxation if there are insufficient “uncommitted” assets to allocate to other jurisdictions. This scenario is addressed in paragraph 140 of the Report, of which the final sentence states:

“On the other hand, where such an adjustment [i.e. reducing the allocation of investment assets to the PE to take into account the insufficiency of uncommitted assets] would leave the PE with a lower amount of investment assets than would be held by an independent insurance enterprise... that would indicate that the capital allocation approach did not produce an arm's length result...”

It seems to us that the wording of the two quotes cited above almost endorses double taxation by accepting that the approaches are not compatible. For example, in the case of an enterprise with a number of PEs, even if the capital allocation approach is not adopted for the other PEs (i.e. those not in this position), it is difficult to devise an approach that will both avoid double taxation and be acceptable to the tax authorities of the countries hosting those PEs or indeed the home jurisdiction.

Investment income

Regardless of whether a “top down” or a “bottom up” approach is followed, the key point should be that the enterprise as a whole is not taxed on more than 100% of the investment income included in its financial statements for that period. We believe the Report should state this more clearly as a guiding principle.

In this context we would reject attribution of hypothetical investment income on the basis that a separate enterprise in that particular location “would” have invested in particular classes of asset that “would” have generated particular returns. Such an approach is by its very nature subjective. It seems to us that just as the OECD *Transfer Pricing Guidelines* require taxpayers and tax authorities to apply the arm’s length principle to transactions that have actually occurred, a PE should only be able to be allocated a share of the investment income that the enterprise as a whole has actually generated. Moving away from this approach strays too far into the realm of supposition and conjecture and leaves taxpayers vulnerable to suffering tax on a global basis on more than 100% of the investment income earned by the enterprise.

A further issue in relation to investment income is that, where different GAAPs and tax rules apply, the calculation of investment income or return should not in principle be done in such a way that it brings into the charge to tax in a particular jurisdiction income or gains that are not properly taxable there. For example, if investments are marked to market in an insurance enterprise’s books but a PE jurisdiction taxes the appreciation or depreciation of investments only on disposal, calculating the taxable investment return on the basis of the mark to market books would give a strictly incorrect result.

Secondary adjustments

We would like to see some wording in the Report with respect to secondary adjustments. This is particularly pertinent where investment income which has arisen in another jurisdiction is allocated to a PE under the AOA. The Report should make it clear that the fact that income is allocated to a PE for *Article VII* purposes should not in itself trigger any secondary adjustments such as a requirement to withhold tax in relation to that income.

Reinsurance

Internal reinsurance dealings

The Report comes out firmly against the recognition in most circumstances of internal reinsurance dealings that transfer risk within a single entity. Paragraph 176 states that “no dealing that internally transfers economic ownership of insurance contracts or associated insurance risk is recognised unless it can be demonstrated that another part of the enterprise has performed the relevant KERT function”. Unless, as we have argued above, post-assumption risk management functions can be accepted as KERT functions this paragraph appears potentially to exclude from internal reinsurance dealings any case where there is not a split KERT function in the first place.

Our view is that this approach is too narrow and too prescriptive. We advocate a widening of the wording in this area to make it clear that reinsurance dealings will be recognised if the functional and factual analysis supports it, and that this can in some circumstances be justified where post assumption KERT functions are being performed solely or partially by the part of the entity to which the risk has been transferred. The wording in paragraph 177 in relation to active decision making in the risk management function should in our view also be modified to reflect our earlier comments on this area.

Allocation of external reinsurance

The Report does not, in our view, currently give sufficient guidance as to how the external reinsurance costs incurred by an insurance enterprise should be allocated across its constituent parts. As these can be one of the most significant costs of an insurance enterprise, we think the Report should have some more detailed guidance on this point. The allocation of external reinsurance to parts of an enterprise of course will affect both the costs (largely the premium that the enterprise pays out) and any income that it receives under the reinsurance contract (the reinsurance recoveries following a successful claim under the policy).

In our view it would be useful if the Report were to state that external reinsurance costs (and as the case may be income) need to be allocated across the enterprise according to the facts and circumstances. Reinsurance policies vary greatly, and at one end of the spectrum it should be relatively easy to make an allocation – for example, in the case of a whole account quota share under which the reinsurer accepts a set percentage of every risk that the insurer assumes, it would be reasonable to allocate the costs in line with the premium income across the whole enterprise. However, other reinsurance policies will require closer examination to determine which parts of the entity are deriving the economic benefit, and so should be allocated the costs and any income. Examples where such analysis is needed are policies that reinsure only part of the enterprise's insurance risk, whether by line of business or geography. We believe that it would also be useful to mention in particular stop loss or excess of loss contracts under which the reinsurer provides cover if losses exceed a certain level: as with these policies the chances of triggering a claim depend crucially on the volatility within the book of business it will be necessary to analyse the facts to determine the correct allocation under transfer pricing principles.

We hope these comments are helpful. We will be happy to clarify any issues if you would like us to do so, and will also be pleased to contribute to the consultation on 26 November.

Yours sincerely

David Clissitt
Partner

Giles Hillman
Associate Partner