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**OECD DISCUSSION DRAFT OF THE REPORT ON THE ATTRIBUTION OF PROFITS TO PERMANENT ESTABLISHMENTS – PART IV (INSURANCE) ISSUED AUGUST 22, 2007**

On behalf of the XL group of companies (“XL”), I am pleased to respond to the request for comments on the OECD revised public discussion draft of the report on the “attribution of profits to Permanent Establishment - Part IV – Insurance”, released on August 22, 2007.

XL appreciates the changes made in the report with respect to defining the functions of the insurance industry and acknowledges that the revised report more accurately reflects the practice in the insurance industry. Nevertheless, there are a number of specific topics that we believe need to be developed further or where more accurate drafting or further clarification are required.

***Attribution of underwriting income***

*Assumption of Insurance Risk and KERT definition*

Paragraph 69 of the report explicitly states that an insurance business will have one key entrepreneurial risk taking function (“KERT”): “*the assumption of insurance risk by performing the underwriting function described in Section B-2(i)(c)*”. Although we agree that an insurance business can, depending upon facts and circumstances, have only one KERT, we believe that generally the KERT for insurance is broader than underwriting.

Paragraphs 34-37 of the report attempt to widen “underwriting” and more adequately explain the spectrum of possible insurance risk assumption activities; however we do not believe this is sufficient. As suggested in the latter part of paragraph 69, we feel that in all circumstances the range of activities that make up insurance risk assumption must be analysed in order to identify the appropriate KERT. We therefore support the approach of BIAC and CEA that paragraph 94 should be used as a starting point.

We would point out however, that we do not regard risk management as ancillary to the function of underwriting insured risks. We believe that the KERT of “assuming insurance risk” can and does include risk and capital management under certain facts and circumstances. Risk management is a key function for the industry that does not only occur prior to the assumption of the (re)insurance risk. Indeed, after the initial assumption of the (re)insurance risk, the risk management function will sometimes make active decisions as to whether the risks should be retained or ceded and this can directly influence the capacity of the company to accept (re)insurance risk as well as the pricing. In our view, the KERT is capable of including the setting of the underwriting policy, the risk selection, the pricing of the product, the acceptance of the insured risk, the risk management function (whether prior to the risk assumption or subsequent to it), the risk retention analysis and the capital management and therefore the definition KERT should be widened to take into account the full range of activities that may, depending on the facts and circumstances, contribute to the function of “insurance risk assumption”

As BIAC and CEA suggest, this change can be incorporated throughout the document by replacing the term “underwriting function” with “insurance risk assumption function”, noting (as in paragraph 94) that such a function could be any one of a broad spectrum of activities depending upon the type of business. Like BIAC and CEA, we do not want to complicate the calculation, but the activities that contribute the most to the profitability of a PE should be deemed to constitute the KERT, which then in turn determines “economic ownership” of assets and the attribution of the underwriting profit.

## *KERT – Quantification*

Paragraph 98 states that “the function of assuming insurance liabilities is performed by personnel. So it should be possible to determine whether the key entrepreneurial risk-taking function is performed by the PE by considering whether the people performing that function are located in that PE.”

We do not consider that the existence of people alone drives the KERT, but rather that the functions themselves are the drivers. We would therefore suggest that paragraph 98 is changed to reflect the importance of where the KERT functions actually occur, as opposed to necessarily where the personnel are located.

## **Allocation of investment assets**

### *Definition of investment assets*

There appears to be an assumption, within the report, that the assets required to support the insurance risk and hence meet the reserves and surplus requirements created by that risk, would only be income bearing assets generating an investment return in the form of dividends, interest, rents or capital gains. However, insurance companies may (and largely do) cover insurance risks by holding non income bearing assets (e.g., due and accrued premiums, reinsurance recoverable). These assets are intimately tied to the insurance activities although they are not “investment assets” as such.

It is our belief that the “assets” to be allocated to the various parts of the enterprise assuming insurance risk must include non interest bearing assets linked to the insurance business. The definition of ‘invested assets’ either needs to be expanded to include non interest bearing assets that are either related to insurance activities or to surplus or such assets could be referred to as ‘financial assets’. Whatever you call them, the definition is important because assets supporting reserves and surplus do include assets such as due and accrued premiums, reinsurance recoverables, other insurance related receivables and funds withheld.

### *Calculation of the yield on investment assets*

As regards other investment assets which are income bearing, it is acknowledged that some of these assets might be “under-performing” or non-performing” (see paragraph 167 of the report). In this respect, the report states that “*adjustments*” should be made on the yield to “*prevent “distortion” in investment returns on accounts of investments in “under-performing” or “non-performing” assets or assets denominated in currencies subject to high rates of inflation*” (paragraph 167). We would like to obtain a confirmation that these adjustments should not result in an allocation of a total investment income greater than the actual investment income of the company as a whole (including investment income from trusted assets).

It is acknowledged, in paragraph 167 of the report, that “*determining the appropriate investment return to apply to an insurance company’s “uncommitted” investment assets under the authorized OECD approach may present particular challenges*”. The paragraph goes on to suggest that “*One practical method of determining the investment return would be simply to assume that the investment return is equal to the investment return on all investment assets held by the company*” (the so-called “top-down” approach). We believe that this statement is incomplete as it does not acknowledge the fact that all assets held by an insurance company which are linked to the insurance business do not necessarily qualify as “investment assets”, as currently defined. In this respect, we believe our revised definition (see our comments above) of ‘invested assets’ or “financial assets” should be replicated in the comments made in paragraphs 165 to 170 regarding the calculation of the yield.

*Impact of regulation*

It is proposed that the quasi thin-capitalization method (allocation of surplus by reference to the minimum amount of surplus which would be required for regulatory purposes in the host country for an independent enterprise) is not recognized as an authorized OECD approach, but should be treated as a safe harbor method only. Whilst recognizing the importance of regulation, the report concludes that the regulator's position is "*persuasive but not determinative*" (paragraph 97).

However, the quasi thin capitalization method is an approved method for regulators and should be a valid method to assess the arm's length amount of capital needed in the host country. We believe that the creation of tax rules which conflict with regulatory rules is counterproductive and will impose a burden on the taxpayer and we therefore suggest that the quasi thin capitalization method may be used as an approved OECD approach in certain instances based on facts and circumstances.

I would like to participate in the consultation meeting taking place on 26 November and would be happy to discuss any of the above topics in more detail. My contact details are as follows:

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