



ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT



REPORT ON THE ATTRIBUTION OF PROFITS TO PERMANENT ESTABLISHMENTS

PART IV (INSURANCE)

*Revised public discussion draft
22 August 2007*



CENTRE FOR TAX POLICY AND ADMINISTRATION

22 August 2007

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

Revised public discussion draft

In June 2005, the Committee on Fiscal Affairs released for public comment an initial discussion draft of Part IV (Insurance) of the Report on the Attribution of Profits to a Permanent Establishment. A consultation meeting with representatives of the insurance industry and other interested parties was held on 31 March 2006. The tax administrations from 14 countries and over 40 private sector participants were present at the consultation.

The Committee wishes to thank the individuals and organisations that provided comments on the discussion draft. Working Party No. 6 on the Taxation of Multinational Enterprises¹ has carefully considered all the comments received (available on the OECD website; see http://www.oecd.org/document/56/0,3343,en_2649_33753_35428216_1_1_1_1,00.html) and reviewed the discussion draft in light of those comments and also in light of the revised versions of Parts I-III of the Report published in December 2006.

The revised draft of Part IV, which appears below, was prepared in light of those developments. The Working Party decided that this revised draft should be publicly released for comments with a view to continuing the discussion of this proposed part of the Report in light of comments from interested parties. The Working Party also intends to hold a consultation meeting with interested commentators on this revised discussion draft in Paris on Monday, 26 November 2007.

Interested parties are invited to send their written comments on this revised discussion draft by **31 October 2007**, preferably in the form of a Word document electronically delivered to:

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Commentators who also wish to participate in the consultation meeting through the presentation of oral comments are requested to so indicate in their written submission and to include: (i) the name and contact details of the individual or individuals who wish to present the oral comments; and (ii) an outline of the topics to be discussed. Please note that the consultation will be held in English only (no interpretation). The OECD will respond to all commentators' requests to participate in the consultation within one week after the close of the comment period. Due to room size limitations and in order to keep the group reasonably small for a more efficient dialogue, it may not be possible to accommodate everyone who wishes to attend. Please note that, unless otherwise requested at the time of submission, comments submitted to the OECD in response to this invitation may be posted on the OECD website.

¹ That Working Party is the sub-group of the OECD Committee on Fiscal Affairs which is responsible for updating the OECD Transfer Pricing Guidelines.

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PREFACE

1. The permanent establishment (PE) concept has a history as long as the history of double taxation conventions. Currently, the international tax principles for attributing profits to a PE are provided in Article 7 of the OECD Model Tax Convention on Income and on Capital, which forms the basis of the extensive network of bilateral income tax treaties between OECD Member countries and between many OECD Member and non-member countries.

2. There is considerable variation in the domestic laws of OECD Member countries regarding the taxation of PEs. In addition, there is no consensus amongst the OECD Member countries as to the correct interpretation of Article 7. This lack of a common interpretation and consistent application of Article 7 can lead to double, or less than single, taxation. The development of global trading of financial products and electronic commerce has helped to focus attention on the need to establish a broad consensus regarding the interpretation and practical application of Article 7.

3. As a first step in establishing a broad consensus, a Working Hypothesis (WH) was developed as to the preferred approach for attributing profits to a PE under Article 7. This approach built upon developments since the last revision of the Model Commentary on Article 7 in March 1994,¹ especially the fundamental review of the arm's length principle, the results of which were reflected in the 1995 OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (the Guidelines). The Guidelines address the application of the arm's length principle to transactions between associated enterprises under Article 9. The basis for the development of the WH was to examine how far the approach of treating a PE as a hypothetical distinct and separate enterprise could be taken and how the guidance in the Guidelines could be applied, by analogy, to attribute profits to a PE in accordance with the arm's length principle of Article 7. The development of the WH was not constrained by either the original intent or by the historical practice and interpretation of Article 7. Rather the intention was to formulate the preferred approach to attributing profits to a PE under Article 7 given modern-day multinational operations and trade.

4. To meet the policy goals described above, the WH was tested by considering how it could be applied in practice to attribute profits both to PEs in general and, in particular, to PEs of businesses operating in the financial sector, where trading through a PE is widespread. A Discussion Draft containing the interim results of testing the application of the WH to PEs in general (Part I) and to PEs of banking enterprises (Part II) was released for public comment in February 2001. Twenty-five responses were received from the business community, banking associations and advisory firms, reflecting a diversity of views and interests. Because of the variety of positions expressed and the complexity of the issues, a consultation was held in Paris in April 2002 with the commentators on the Discussion Draft. The consultation was very valuable as it allowed the identification of common ground in terms of principles, of areas that needed further clarification and of areas where further work was needed.

¹ This revision followed the publication of "Issues in International Taxation No. 5: Model Tax Convention: Attribution of Income to Permanent Establishments" reproduced in Volume II of the loose-leaf version of the OECD Model Tax Convention at page R(13)-1.

5. A revised Part II and a Part III (Global Trading) were released for public comment on 4 March 2003. Nineteen responses were received from the business community, banking associations and advisory firms. Again because of the complexity of the issues, a second consultation was held in Geneva in March 2004. A first revised version of Part I, which renamed the WH as the authorised OECD approach (AOA), was released for public comment in August 2004. Second revised versions of Parts II and III were also released to commentators in August 2004, and a meeting with selected commentators on Parts I-III was held in Paris in October 2004. Final revised versions of Parts I-III were published in December 2006. An initial version of Part IV (Insurance) of the discussion draft was released for public comment in June 2005. The comments received were discussed with business representatives at a consultation held in Paris on 31 March 2006. This revised version of Part IV takes account of the comments received and the discussions held during that consultation.

6. Once Parts I-IV of the Report are finalised, their conclusions will be implemented through amendments to the Commentary on, and/or the text of, Article 7. Specifically, the CFA has decided that implementation should take place in two stages in order to provide maximum legal certainty in the interpretation of both existing and future treaties. The first stage will be a revised Commentary on existing Article 7, importing the Report's conclusions that do not conflict with the existing Commentary. The second stage will be a new text for Article 7, together with accompanying Commentary, in order to implement the full conclusions of the Report. The task of developing the implementation mechanisms is currently being undertaken by a Joint Drafting Group (JDG) made up of representatives from the CFA's Working Party No. 1 on Tax Conventions and Working Party No. 6 on the Taxation of Multinational Enterprises. The CFA released a public discussion draft of the first part of the implementation package in April 2007 and expects to release for public comment a draft of the second part of the implementation package by the end of 2007.

**PART IV: SPECIAL CONSIDERATIONS FOR APPLYING THE AUTHORISED OECD
APPROACH TO PERMANENT ESTABLISHMENTS
OF INSURANCE COMPANIES**

A. Introduction

1. Part I of this Report sets out the principles of the authorised OECD approach and provides guidance on the practical application of these principles to attribute profits to a permanent establishment (PE) in general. However, it is also considered necessary to supplement this general guidance with more specific and practical guidance on the application of the authorised OECD approach in commonly occurring factual situations. Parts II and III of this Report discuss special considerations in applying the authorised OECD approach to PEs in the context of traditional banking businesses and global trading in financial instruments. This Part of the Report (Part IV) looks at the insurance industry and discusses how the authorised OECD approach applies to situations commonly found in enterprises carrying on an insurance business through a PE. More specifically, Part IV applies the authorised OECD approach to the operation of property and casualty insurance, life insurance, and reinsurance activities.

2. The insurance industry presents a number of unique challenges to tax authorities. Traditionally, the nature of the ongoing relationship created by insurance resulted in customers dealing largely with domestic insurers with whom they were comfortable. However, the insurance industry rapidly is becoming more global. Cross-border merger and acquisition activity is increasing, which will result in greater consolidation of the industry. As a result, tax authorities may find it difficult to find useful comparable transactions for the purpose of doing a transfer pricing analysis. Insurance companies may find it advantageous to operate through PEs in a number of jurisdictions, rather than through subsidiaries, because certain host state regulators rely on regulation by the home state and so may impose a lower capital requirement or none at all. Host states may not have developed rules for attributing profits to such PEs, or there may be questions about whether those rules, where they exist, are fully compatible with their existing treaty obligations.

3. Finally, some companies are exploring the use of electronic and faxed communications, or the Internet, to issue policies cross-border without establishing physical PEs (the activities may nevertheless constitute a PE under Article 5 depending on the particular facts and circumstances).

4. Section B of this Report provides a general but not definitive functional and factual overview of an insurance business. Section C discusses how the authorised OECD approach applies to a PE of an enterprise carrying on insurance business. Section D discusses whether Article 7(4) should be deleted from the OECD Model Tax Convention. Finally, Section E discusses Article 7(7). It should be noted, that under the AOA, the same principles should be applied to attribute losses as to attribute profits. References to attributing “profits” should therefore be taken as applying equally to attributing losses.

B. Functional and Factual Analysis of an Insurance Business

B-1. General Overview

5. The insurance business is the business of accepting obligations or liabilities in respect of uncertain losses arising from the realisation of events outside the control of the insured. Insurance businesses are able to do this by pooling the potential losses of many risk-averse persons via the payment of an amount by the insured to the insurer, called a premium (see paragraph 8 below for a description of how losses can arise in different types of insurance business). In consideration of the payment of the premium, when the insured incurs a loss or a specified event occurs, he, she or a beneficiary is indemnified for the amount of the value of his or her loss or receives an agreed payment or service.

6. The pricing of the premiums must take into account the insurer's expected costs of claims and the time when claims are expected to be paid. It will also have to take into account the ratio of expected operating expenses to premiums. The insurer will invest premiums to earn a return, and this return will be taken into account in the insurer's calculation of the appropriate level of premium.

7. The term "risk" may have different meanings and it is important to differentiate between risks of losses to which the policyholder (premium payer) may be exposed and the risks assumed by an insurance corporation in extending insurance coverage to policyholders. For the rest of this document, the term "insured risk" refers to the potential losses of the policyholder for which the policyholder seeks coverage and for which the insurer agrees to provide coverage, and the term "insurance risk" refers to the risk assumed by the insurer (the very essence of the business of insurance) in agreeing to extend coverage to policyholders. Thus, in agreeing to extend insurance coverage to policyholders by accepting their insured risks, an insurer must assume and manage insurance risk.

8. In agreeing to cover insured risks, the insurer, to the extent that there is potential for the amount and timing of actual claims cash flows to differ from the expected claims profile, takes on insurance risk. This is also called underwriting risk (see paragraph 56 for a description of the subcomponents of underwriting risk). Generic business risks that the insurer faces are discussed in Section B-4(i), below, where it is indicated that the approach in Part I is to be followed. To the extent that an insurer assumes underwriting risk, it will command a risk premium that will compensate it for the risk it is assuming. Thus for an insurer that takes on very risky or more volatile forms of insurance, the premium required by the insurer will include a greater element of profit than for less risky forms of insurance.

9. Three parts of the insurance industry can be distinguished and are the focus of this Report: the life and health industry (usually referred to as the "life" or "long-term" insurance industry), the property and casualty industry (usually the "P&C" or "general" industry) covering all insurance business other than life or health, and the reinsurance industry. Life insurers concentrate both on replacing the financial loss resulting from the death or illness of individuals and providing savings products. Life insurers also provide insurance-related services for which the insurer earns fees (*e.g.* large group health plans). P&C insurers generally insure the risk of financial loss arising from damage or loss of property through fire, theft or third party liability. Reinsurers provide insurance on risk of underwriting loss for both P&C and life insurers.

10. An insurance enterprise may be organised in one of many possible legal forms. The enterprise can take the form of stock insurers (those with share capital), mutual insurers (no share capital; policyholders are effectively the owners), co-operatives (such as farmer co-operatives), and fraternal or affinity benefit societies (which may typically be created by athletic associations, religious or ethnic groups).

11. Insurance businesses may organise themselves in foreign jurisdictions in both subsidiary and PE form, in some cases dictated by regulatory requirements (and in other cases a reduced cost of capital may ensue).

i) Income and Capital (Surplus) in the Insurance Business

12. Two important sources of income for insurers are underwriting premiums and investment income. Underwriting income is the insurer's net income from the pure insurance elements of its business, being the balance found after deducting expenses and claims (including any movement in provisions for outstanding claims) from the premium income. It does not include investment returns (income and gains on investment assets). Insurance companies hold substantial amounts of investment assets. These assets may arise from premiums received from policyholders in exchange for insuring risks, from the balance of retained profits and losses and from capital provided by stockholders.

13. In the case of life insurance, it may be more difficult to separate profit into underwriting and investment components due to the long-term nature of the business, especially in jurisdictions where the enterprise is not required to report the two separately in its financial statements. In addition, life insurers may earn fees for providing insurance-related services (e.g. large group health plans). Another source of income for all three types of insurance companies may come from providing "fronting services", such as underwriting and claims administration, to foreign unlicensed insurance companies (including offshore captives).

14. Insurance contracts give rise to claims for insured losses or benefits that may not be payable for many years, while the premium income received from those contracts (and returns from its investment) and associated with those future expenses is received and reported as income in the current year. But a substantial portion of the income is simply to fund future insured losses or benefits. Accordingly it is appropriate to set aside an amount to reflect the future costs in the form of a reserve taking into account the cyclicity of different business lines. Since this reserve is for a future claim or benefit payment it is a liability to the insurer. An attempt is made to place the insurer's income on an accrual basis by matching the timing of the inclusion of premiums (and investment returns) in income with the timing of the deduction from income for the reserve.

15. The nature of insurance business creates a requirement for surplus to absorb any losses or benefits in excess of reserves from the realisation of those insured risks. Surplus may also be used to support product development, marketing, and other functions depending on the nature of the business. Capital means the equity of an insurance company, but the term has a multitude of facets. It is used as an accounting term (paid-in capital and accumulated profits or losses not distributed to shareholders). It is also extremely relevant for regulatory purposes (where capital is often referred to as "surplus" or "free assets") and is defined under the various country-specific regulatory provisions. It is also used in connection with creditworthiness (ratings issued by independent rating agencies to indicate level of financial strength to clients and creditors), which is particularly important for long-term business (also see Section B-4(ii) which discusses the importance of creditworthiness).

16. Throughout Part IV of this Report, equity in the insurance industry will be referred to as "surplus". Surplus consists of the excess of assets over reserves and other liabilities and includes paid-in capital of shareholders plus any accumulated profits (and net of any losses) not paid out as dividends. The insurer, in order to be able to assume and manage insurance risk, must have surplus, and the amount of surplus it has determines the amount and type of insurance risk it can assume and manage. The marketplace, rating agencies and regulators determine the minimum amount of surplus required in order to undertake insurance risk in various lines of business.

17. This Report seeks to provide guidance on how to determine which part of an insurance enterprise performs the various functions involved in the assumption and management of insurance risk (and so should receive the associated insurance underwriting income). It also acknowledges that insurance companies may provide services other than pure insurance, for example the administration of medical plans or asset management services. Guidance will also be provided on how to determine an appropriate attribution of investment assets, representing surplus and reserves, to the various parts of the enterprise, taking into account any regulatory conditions imposed by the host country, thereby determining the attribution of the associated investment income.¹

ii) *Role of Reinsurance*

18. Reinsurance is a mechanism through which insurers can manage insurance risk by shifting or ceding one or more insured risks to reinsurers in exchange for payment of premiums. As a result of the reinsurance, the ceding company may reduce or credit its reserves for the insured risks ceded to the reinsurer. Its assets may also be reduced by the amount of the consideration paid to the reinsurer for accepting those insured risks. Accordingly, reinsurance agreements reduce the risk assumed by the insurance company, thus alleviating the requirement for surplus with respect to the insurance risk. The reinsurer is able to pool the risks ceded to it by one insurance company with risks ceded by other insurance companies, thereby diversifying its risk pool and potentially allowing the reinsurer to maintain a lower amount of surplus with respect to the risks ceded to it by any single insurer than that insurer might have been required to maintain on its own with respect to those risks. It should be noted that even if all the insured risks were to be reinsured, some risk would remain to the original insurer, *e.g.* the credit risk that the reinsurer does not pay up under the reinsurance contract. This default risk has led some regulators to limit the amount the insurance liabilities can be “credited” for the ceded insured risks; *i.e.* the amount by which the technical reserves are reduced. Insurers may try to minimise this default risk by ceding risks to more than one reinsurer. By allowing insurers to tailor their insurance risk, reinsurance plays an important role in the efficient functioning of insurance markets.

19. Reinsurance provides a means for freeing up surplus that will allow the insurance enterprise to take on other types of insured risks. Since regulators are responsible for assuring that a minimum level of surplus is available to support the risk assumed by an insurance business they are very concerned with creditworthiness of the reinsurer and its ability to fulfil the payments provided for under the reinsurance contract. If a reinsurer does not have the necessary funds to provide payment when the reinsurance policy calls for that payment, the ceding company, in effect has not freed up surplus by entering into the reinsurance contract. Regulators, who recognise this problem, will frequently require that the reinsurer set up a trust or other type of fund or collateral that contains the necessary amounts called for in the reinsurance contract. When the reinsurer is in another jurisdiction, the regulator has no control over the financial health of the reinsurer, and thus some jurisdictions require that such a fund be created in the home country of the ceding company. The creation of a trust or similar type of fund raises a number of issues under the authorised OECD approach (see Section C-1(iii) for further discussion).

20. A reinsurance contract is an agreement between an insurer and a reinsurer. The insurer writes the policy for the policyholder and is contractually responsible for any payments to the policyholder that come due under the policy, even if those insured risks are ultimately met by a reinsurer as part of a reinsurance contract. The insurer markets the policy, bears the costs of its sale and ongoing administration and receives the premium income associated with the policy. In a reinsurance contract, the insurer (cedant) cedes the insurance risk to a reinsurer in return for the payment of the reinsurance premium. In return, the cedant

¹ In this Report the terms “reserves”, “technical reserves” and “technical liabilities” are used interchangeably.

receives a payment (referred to as a ceding commission) intended to cover the portion of the costs that it incurred in obtaining the policy and to produce a profit. Generally, the result is a net payment made by the cedant to the reinsurer. However, it is acknowledged that reinsurance contracts may in certain market conditions create a loss where ceding commission paid by the reinsurer does not cover the insurer's costs or where a negative ceding commission is paid to the reinsurer.

21. Reinsurance agreements can take several forms including:

- *Facultative reinsurance*, which is a basic form of reinsurance agreement in which the reinsurer assesses each insurance policy before agreeing to reinsure the insured risk. Facultative reinsurance is typically used for very large single insured risks.
- *Treaty reinsurance*, which is a basic form of reinsurance agreement in which a contract (which may be for some fixed period of time) is undertaken whereby the reinsurer agrees in advance to accept a specified amount or proportion of all insured risks or losses as defined in the treaty, for example, from a particular line of business or product. A reinsurer will base its willingness to accept the insured risk upon the experience and reputation of the ceding company.

Under either type of contract, the reinsurer and insurer share insured risks on some agreed basis. There are two main types of insured risk sharing arrangements:

- *Proportional reinsurance (or quota-share reinsurance)* is an insured risk sharing arrangement where the reinsurer reinsures a certain percentage of each of the policies written by the ceding company during the term of the contract. This kind of reinsurance can be used when the capital available to the insurer is limited relative to its capacity to market policies.
- *Excess of loss reinsurance* is an insured risk sharing arrangement that provides that the reinsurer will pay the ceding company to the extent that the ceding company's losses from a particular line of business or specified event exceed a certain amount.

This sub-section does not deal with assumption or novation reinsurance, *i.e.* a form of insurance transfer under which the reinsurer acquires the policies whose risks are reinsured and has a direct contractual relationship with the policyholder thereafter.²

22. Section C-1(v) discusses the difficult question of internal reinsurance within a single enterprise.

B-2. Functions Performed

23. This section analyses the most important functions of a traditional insurance business. It does not attempt to be definitive, as other functions might have an important role in the insurance business, too. Following the approach in Chapter I of the Guidelines, the analysis of functions performed also takes into account the assets used and risks assumed in performing those functions. The focus of the discussion in this section relates primarily to the functions performed in a property and casualty business. However, most of these functions are also performed by life insurance and reinsurance companies, to varying degrees. In addition, the relative importance of these functions to the profitability of an insurance business

² Depending upon applicable law, assumption reinsurance may effect a novation which relieves the ceding insurer of any further liability to a policyholder.

depends upon various factors, including the type of insurance business (P&C, life or reinsurance), the line of insurance business and products sold in that business.

24. The operational functions are the functions that must be performed in order for an insurance enterprise to assume insurance risk. The following sub-section describes the most important operational functions of a traditional insurance business.

i) Functions of an Insurance Business

25. The functions are discussed in this Report in terms of a value chain describing the business processes in the insurance industry starting with the development of the insurance product and ending with administration of claims made under the insurance policy and the long-term investment of the assets supporting the insurance liabilities. There are other functions related to management and support processes, *e.g.* planning, human resource management, etc., but only those particular to the insurance industry are discussed in this Report. The functions comprising the business process are similar for each of the three parts of the industry listed above (life, P&C and reinsurance), but the relative importance of each function may vary considerably from one category to the next and between different businesses and lines of business. When the functions are generally more important in one category of insurance, that importance will be highlighted in the following sections but it should be stressed that the relevant importance of these functions will vary according to the particular facts and circumstances of each taxpayer.

a) Product management/product development

26. This process comprises the risk-technical, legal and mathematical structuring of the product. In concrete terms, it means assessing the quantitative, qualitative, geographical and time-related features of insurance cover in the context of insured risk acceptance and savings processes. In addition, it involves determining the scope and features of advisory and processing services. The structuring of insurance products must be adapted on an ongoing basis in line with developments in the market, in legislation (including tax legislation) and in claims performance.

27. Important processes of product development involve the following activities: market research, gathering and maintaining (claims) statistics, legal stipulation of the extent of cover, mathematical calculation of the premium depending on the features of insurance cover (geographical, temporal, demographics, policy surrender and settlement options, investment returns guaranteed or anticipated in the pricing of the premium, insurance excess options, etc.).

28. The pricing/setting of premiums for the insured risks to be underwritten for new lines of insurance or products may be performed by the underwriters, although that is generally not the case for life insurance products (where premium rate tables are developed by actuaries). In some cases arm's length third parties may perform some of these functions by providing specialist services to insurance companies. For example, some organisations compile claim statistics and make them available to member institutions. Other enterprises use proprietary mathematical models and processes to produce data for use by their clients in estimating the cost of claims resulting from the weather (flooding, hurricanes, hail, etc.) or other events. Brokers may provide market analysis and research and structure programs to meet client needs.

b) Sales and marketing

29. At first, the general marketing strategy is defined, based on a process that allows identification and analysis of customer needs. The marketing strategy may be segmented into products, regions,

countries, etc. The marketing strategy also encompasses the definition of marketing and acquisition programs, and the development and application of training and educational programs.

30. At the sales stage, the customer's scope of losses and requirements are analysed and a suitable proposal is made. In certain business lines (*e.g.* life insurance), risks of losses and financial security problems are increasingly linked to a multitude of legal parameters of a judicial and fiscal nature, and consumers are frequently overwhelmed when it comes to evaluating their risk of losses and formulating their security needs. In these lines the advisory function is increasingly important, and the advisory process only when provided to the customer by or on behalf of the insurer should be seen as a component of the actual market service regardless of how this added value is organised (in-house or independent sales force, brokers, internet methods, etc.). The various sub-processes involved in sales, marketing and acquisition include acquiring clients, assessing requirements, advising clients and providing quotes and proposals.

31. An insurance contract guarantees the fulfilment of a function over a contractually agreed period of time. The prospect of entering into a longer-term relationship leads to an extension of the business effort beyond the time of the actual sale of the service by providing sales/support functions. The Customer Relationship Management services area's task is to strengthen client relationships, even if no claims payments are made in a certain period. Functions in the "CRM" field include: ongoing analysis of the client's insurance needs, adjusting requirements, preventing termination, utilising cross-selling opportunities, handling complaints, etc. Customer relationship management potentially benefits insurance companies in a number of ways. It may help reduce persistency ("lapse") risk (specific risks are commented on in Section B-4) encountered in the life insurance industry by encouraging policyholders not to terminate their policies or cause them to lapse. It may reduce underwriting risk by providing direct claims experience with the policyholder over longer time spans. It may also assist the insurer in differentiating itself from other insurers thus lowering marketing costs/efforts. There also are risks to the insurance enterprise if the sales and marketing functions are not properly performed so that its products are mis-sold to a customer, *e.g.* the products were not properly explained to the customer or the product was not suitable.

32. Insurance agents and brokers undertake sales and marketing functions by trying to cultivate potential clients and to create client relationships. The exact nature of the sales and marketing function depends on the type of insurance, *e.g.* life insurance is aimed at the retail market and so the nature of the marketing function will be quite different from that of a life reinsurer where the market is other insurance companies and insurance agents or brokers are often not involved. The relative importance of the function will also depend on the facts and circumstances. For example, for some products that are intrinsically profitable in insurance terms, such as travel insurance, the marketing function is likely to be important, whilst for other products such as credit card insurance the development of a relationship with the credit provider will be vital. To carry out the sales and marketing functions, many insurers rely on independent agents and brokers; others rely on their own sales staff including those of other companies, such as a bank, in a financial group. There is a growing trend to selling directly by phone and the internet. In general, brokers act as an intermediary and represent the insurance buyer. Agents represent the insurance company. In the case of reinsurance, the broker's client is the insurance company (cedant). The use of brokers may be more prevalent in the large commercial and reinsurance market segments whereas agents may be found more frequently in small commercial risks and personal lines. The significance of each of these distribution channels may also vary by country as well as by geographic region.

33. Companies in the international property and casualty business and the reinsurance business rely very heavily on brokers to source or provide insurance. In many cases, these brokers are under fiduciary obligations to act on behalf of clients and buy insurance from many insurance companies. Such brokers may perform underwriting-related functions to facilitate the underwriting, *e.g.* by gathering information relevant to the insured risk, preparing the preliminary terms of a contract and managing any claim. In some

cases, the brokers have authority to bind insurance companies, provided that the prospective insured satisfies a specified profile. Thus, in many cases, brokers perform functions that go beyond sales and marketing.

c) Underwriting insured risk

34. Underwriting is the process of selecting and pricing the insured risks to be accepted. Again, the exact nature and importance of these functions (and who performs them) will vary depending on the type of insurance product and the facts and circumstances of the taxpayer. For example, the risk selection part of underwriting is likely to be less important for certain types of standardised products (e.g. low value life insurance products) and for reinsurance where product development and pricing, marketing and risk management/reinsurance functions may be more important. There are a number of activities that can contribute to the “underwriting” process. It will be important in the functional and factual analysis to evaluate the relative contributions of the following activities to this activity (see paragraph 69):

- *Setting the underwriting policy.* Defining an underwriting policy which the underwriters have to follow is part of risk management. The underwriting policy may set broad or detailed parameters for determining the amount of risk to underwrite and can be designed to ensure that the insurer writes a book of business that is profitable and reasonably stable. The extent to which it actively contributes to the underwriting process will need particularly careful analysis.
- *Risk selection.* The process of selecting the insured risk is underwriting in a narrow sense. The underwriter analyses the specific risk and related risk category, and determines the pricing according to risk, cost and market conditions, or according to the applicable premium rate tables. Further, the underwriter may select the risk and verify capacity limits. The basic requirements are the classification of risks on the basis of selected criteria and the use of relevant statistics.
- *Pricing.* The underwriter may be involved in the pricing or setting of premiums for a contract but, where the product is standardised and premiums are set by reference to applicable premium rate tables, the underwriter is generally less involved in the pricing of the contract once the risk has been classified. In the life insurance business, the underwriter is generally only involved in the selection and classification of the insured risk and the pricing of the insured risk is done by actuaries.
- *Risk retention analysis.* Part of the underwriting decision may involve an analysis of how much of the insured risk should be retained and how much can and should be simultaneously laid off to a reinsurer and on what terms.
- *Acceptance of insured risk.* The decision to enter into the contract is the underwriting activity that exposes the enterprise (and its surplus) to insurance risk. That may be performed by an underwriter who at one extreme will exercise considerable independence and skills and at the other will be more like a salesperson with look-up tables.

35. The 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. Defining an underwriting convention or practice which the underwriters have to follow is part of risk management and will be appropriate to the technical skills and abilities of the insurer’s personnel. The underwriting policy may set broad or detailed parameters for determining the amount of risk to assume, determines the nature

and size of business of an insurance company and may, depending on the facts and circumstances of the taxpayer, be one of the major factors affecting the profitability of insurance operations. Factors which may influence the underwriting practice are:

- (1) the financial capacity of the company, essentially its surplus;
- (2) the regulatory framework concerning the maximum risk capacity;
- (3) the technical skills and abilities of personnel;
- (4) the availability and cost of third party reinsurance; and
- (5) strategic business goals.

36. The basic requirements are the classification of insured risks on the basis of selected criteria and the use of relevant statistics. For standardised products, this procedure may be to a certain extent automated. In the case of complex contracts, the process is very complex (comprehensive insured risk verification) and requires very strong specialist skills (insured risk engineering, explanation of judicial, medical, physical implications, etc.). In particular, the following sub-processes are involved in executing the contract: processing the proposal, underwriting insured risk, preparing the contract and commissioning. These activities may be carried on by underwriters but may require the assistance or approval of other personnel such as actuaries (*e.g.* to assist with pricing and assess the likelihood of claims), legal staff (*e.g.* for contractual advice) and support staff for administrative matters (*e.g.* premiums and claims processing).

37. Underwriters may be located in the head office of the insurer or in the PE depending on the product line involved. The underwriting function may be supported by the head office's provision of broad underwriting guidance or parameters to be followed by the PE while the PE performs the underwriting decisions of individual risks. In the case of large or specialised policies, the head office may be performing the underwriting. Even when the underwriting function occurs in the head office, there may be situations where valuable underwriting support is provided by the PE, such as where there is a need for an underwriter in the PE to visit the client, or for a sales agent to make a presentation or just to get a better understanding of the insurance needs of the client's business. It will be necessary to determine, through a functional and factual analysis, where the underwriting components are being performed and the value of those components in the particular circumstances.

d) Risk management and reinsurance

38. The overall risk of an insurance company is comprised of separate elements (underwriting risk, commercial risk, environmental risk and investment risk). Underwriting risks are often the most important risk elements, although risks associated with investment may be just as (or more) important, particularly in the case of longer-term business. These risks include asset/liability mismatch, asset default, reinvestment, and volatility risk. Underwriting risk and investment risks are traditionally dealt with within the overall risk management function. To manage these risks, insurers have a comprehensive range of risk management tools (claims adjustment policy, portfolio policy, reinsurance policy and investment policy including ALM (asset liability management)). The calculation of premiums and the analysis of the claims experience (probabilities, claims distribution, etc.), the setting of investment assumptions, as well as setting aside the necessary reserves, are the tasks of actuaries.

39. The risk management function also comprises the capital management, *i.e.* establishing and maintaining a capital management process (including the setting of target rates of return on capital and monitoring progress against those targets), performing the capital allocation to the various lines of business and parts of the organisation (considering, among others, the different solvency regulations and capital requirements). Accordingly, capital management and allocation is a highly complex area.

40. Of central importance to this value-added process is the function of third party reinsurance. It involves the partial transfer of the underwritten insured risks to a reinsurer. Key components of this process are: analysis of the insured risk portfolio, establishing the reinsurance requirements, negotiating, structuring and concluding agreements with the reinsurer, financial execution of the reinsurance transaction, ongoing co-operation with the reinsurer (managing statistics, distributing information, etc.). From the reinsurer's perspective, its functions relative to insurers are broadly similar to those of primary insurers relative to policyholders. Thus, the reinsurer diversifies the risks that are ceded to it by multiple insurers and may in turn cede risks to other reinsurers. The reinsurer has a sales function (*e.g.* through performing marketing activities), performs underwriting activities (*e.g.* by accepting ceded risks from insurance companies and determining reinsurance premiums), performs pooling activities (*e.g.* by pooling the risks ceded to it by multiple insurance companies, monitoring the development of risk and managing portfolios of risk) and performs asset/liability management activities.

41. Over and above this traditional form of risk transfer, new methods of risk financing have been discussed and employed for some time now (ART: Alternative Risk Transfer). The multitude of innovative approaches are firstly aimed at overcoming the barriers to insurability and secondly at optimising the management of the underwriting risk from the point of view of both diversification and cost. The essential feature of ART products appears to be that they import the techniques of the capital markets into insurance through securitisation, often through use of special purpose vehicles to issue securitised financial products. The most common form of securitised insurance product is the catastrophe (CAT) bond. This offers a high coupon subject to a specified but infrequent insurance event, *e.g.* an earthquake. If the event occurs the investor's return is reduced or eliminated and in the riskier bonds part or all of the coupon (and possibly part of the principal) may also be lost.

e) Contract and claims management

42. This function includes the monitoring of a contract (or a group of contracts) over its life cycle, *i.e.* maintaining the information on contractual developments, insured risk and occurrences, as well as maintaining accounts on premiums, claims reserves and commissions. It also includes the loss and claim reporting process - the establishment and maintenance of a loss reporting system, developing reliable claims statistics, defining and adjusting claims provisions and introducing measures to protect and reduce claims in future). Claims management includes all the activities related to a client's claim including, processing the claims report, examining cover, handling the claim (working out the level of the claim, clarifying causes, claims reduction measures, legal analysis) and seeking recovery.

43. In today's competitive environment, insurance companies may also provide tangible and intangible emergency help (assistance, replacement in kind, and physical/emotional help for clients) in addition to the purely financial settlement. This can be one way for an insurance company to differentiate itself from its competitors in an attempt to gain market share.

f) Asset management

44. The asset management process has two primary functions:

- Investment Management: The investment management function comprises the short-term asset allocation, security selection, and investment accounting functions. Short-term asset allocation involves the execution of investment transactions within the boundaries of the investment guidelines established by the asset/liability management function (ALM). Security selection is limited by both the investment guidelines and local regulatory requirements. Investment

accounting is a necessary part of investment management, ensuring proper recording and performance monitoring.

- **Asset/Liability Management:** For long-term insurance business, it is important to match the maturity of asset portfolios with liabilities for the period of risk. ALM establishes investment guidelines for a line of business or a product line. These investment guidelines generally define the longer-term asset allocation policy (including acceptable classes of securities, credit and other risk parameters, maturities) taking into account the nature and term of the liabilities, product guarantees and options, and regulatory requirements.

45. Investment advisors carry out the asset management functions of the insurance business. They make investments out of the reserves and surplus that the company maintains and monitor the risks associated with those investments. In the property and casualty industry they tend to work independently of the underwriters and marketers and since they do not have to interact with the company's clients they can be located far from them. In the life industry the insured may have more control over the investments made so that the connection between the client and investment advisor is closer and requires closer proximity. Investment advisors work with the regulatory compliance personnel since the risk associated with assets is closely monitored by regulatory agencies.

46. Asset management may be carried out in whole or in part by third parties. This may be the case even for large insurance companies with their own in-house asset management group.

g) Support processes

47. An insurance business will also have to undertake a number of support functions some of which are particular to the industry, while others are of a more general nature. Important support functions include:

- *Treasury functions.* The Treasury hedges investments in order to make sure that cash flow is secure and to make sure that the timing of investment income meets the cash flow requirements. It is generally responsible for cash management such as borrowing funds on the most advantageous terms possible. The relationship or distinction between this function and the asset management function would have to be determined through a functional and factual analysis.
- *Regulatory compliance* (e.g. monitoring assets and liabilities, often on a daily basis to make sure that surplus requirements of regulators are met).
- *Systems and development of intangibles* (e.g. development of information technology and systems that can be used to determine pricing and calculate reserves, advertising, claims experience data).
- *Other back office* (e.g. premiums handling, accounting, auditing, legal services, training).
- *Loss control* tries to prevent those losses that can be prevented, minimise those that cannot be prevented and verify valid claims or deny claims for uninsured losses. The loss control department provides input to the underwriters and marketers.
- *Credit analysis* assesses the creditworthiness of the enterprise's various counterparties, including reinsurers, policyholders and persons in whom investments are made.

ii) *Analysis of the Functions Performed*

48. As can be seen from the previous sub-section, there are a number of functions necessary to undertake an insurance business. It will be important to identify not just what functions are performed (taking into account assets used and risks assumed) but also their relative importance.

49. Clearly the determination should be on a case-by-case basis as the relative importance of a given function is likely to vary according to facts and circumstances, e.g. product differences, type of business, business strategies, etc.

50. One area of particular significance for types of insurers that focus on accepting complex insured risks is the identification of the functions which create the greatest value and risks. Such functions require a key decision: the decision as to what insured risks to accept and on what terms. Other functions are usually consequential, for example, which insured risks to reinsure. However, the relative significance of a given activity for a particular enterprise depends upon such factors as the type of insurance operation and the business model employed. As always the analysis depends on the facts and circumstances of the individual case. For example, the process of underwriting complex insured risks is likely to be far more important for complex risks such as life or earthquake insurance than for standardised products such as travel insurance sold over the internet.

B-3. *Assets Used*

51. The Guidelines note at paragraph 1.20 that compensation will usually reflect not just functions performed, but also assets used and risks assumed in performing those functions. So the functional analysis will have to consider what assets are used and what risks are assumed in accepting an insurance contract. For insurance companies, the most important assets used are financial assets, such as bonds, stocks, real estate and cash. These assets are used by the insurance company to generate investment return in the form of interest, dividends, rents and capital gains. Due to the strong link in the insurance business between insurance risk assumed and the need for investment assets to back that risk, the analysis of investment assets used by the PE of an insurance enterprise will have to pay close attention to where insurance risk is assumed.

52. Insurance companies also use physical assets such as sales offices, claims offices, information processing centres, etc., and so the functional analysis will have to consider which non-financial assets are used by the PE. As noted in Section D-2(iii)(b) of Part I of this Report, there is a broad consensus among Member countries for applying the place of use as the basis for attributing economic ownership of tangible assets in the absence of circumstances in a particular case that warrant a different view. These assets may need to be taken into account in making any comparability analysis under the second step of the authorised OECD approach. For example, selling insurance through the internet may be substantially less expensive than selling insurance through a broker or agent, or even directly by phone, because no physical facilities or personnel may be required to make internet sales. Section D-2(i) of Part I of this Report provides further guidance on how to address e-commerce operations under the authorised OECD approach.

53. Further, as with any other business, the functional analysis should also examine whether any intangible assets have been used. In the insurance business, common intangibles are marketing intangibles represented for example by the name and logo of the insurance company. Insurance companies also may have licenses to sell insurance in various markets that are intangible assets obtained at the cost of complying with regulatory licensing procedures. Other intangible assets would be more akin to trade intangibles, such as underwriting tools/tariffs and proprietary systems for efficiently accounting for insurance contracts and monitoring insurance risk and financial risks.

54. The attribution of tangible and intangible non-investment assets to an insurance PE and the pricing of dealings involving such assets give rise to issues that are identical to those found in non-financial enterprises. The guidance in Sections D-2(iii) & (iv) and D-3(iv)(a) & (b) of Part I is therefore applicable to insurance enterprises as well. Part IV is primarily concerned with the attribution of those investment assets to a PE which are appropriate to back the insurance risk assumed by the PE. In the case of an insurance PE, the assumption of insurance risk is the key entrepreneurial risk-taking function which itself requires the attribution of investment assets to the PE to meet the reserve and surplus needs created by that risk. Thus, the initial attribution of economic ownership of an appropriate amount of investment assets to the PE in respect of that key entrepreneurial risk-taking function has primary importance not only for determining characterisation of the “distinct and separate enterprise” under step one of the authorised OECD approach, but also to the attribution of profits under step two, since attributing economic ownership of investment assets attributes the income and expenses associated with holding those assets or lending them out or selling them to third parties.

B-4. Risks Assumed

55. This section discusses the various types of risk assumed as a result of the performance of the various functions necessary to undertake an insurance business. Part II of this Report noted (paragraph 24) that, “[i]n order to assume risk, banks need ‘capital’, *i.e.* the ability to absorb any losses due to the realisation of assumed risks.” Part II went on to note (paragraph 28) that, “the functional and factual analysis would need to pay particular attention to an examination of the issues related to capital adequacy and attribution of capital.” In the context of an insurance business, this section therefore goes on to discuss issues related to the requirement for adequate surplus (capital) as well as other regulatory requirements.

i) Types of Risk

56. An insurance company is subject to many risks for which surplus must be maintained. Aside from direct business risks, significant risks to insurers are generated on the liability side of the balance sheet. These risks are referred to as technical liabilities and relate to the actuarial or statistical calculations used in estimating liabilities. On the asset side of the balance sheet, insurers incur market, credit, and liquidity risk from their investments and financial operations as well as risks arising from asset-liability mismatches. Being attributed risks in the Article 7 context means the equivalent of bearing risks for income tax purposes by a separate enterprise, with the attendant benefits and burdens, in particular the potential exposure to gains or losses from the realisation or non-realisation of said risks. The principal types of risks are as follows.

a. Underwriting risk (also referred to in this document as “insurance risk”) is the potential for the amount or timing actual claims cash flows to differ from expected cash flows. Underwriting risk varies by line of business and its related “tail” (“tail” refers to the lag between the policy inception and loss payment dates), *i.e.* short-tail lines such as auto collision generally have a tail less than two years whereas long-tail lines such as commercial liability may have a tail of 10 to 15 years. Life insurance business (including annuity business) may have an even longer tail which ends upon the death of the life insured or the annuitant.

This risk may include as components/factors:

- Cumulations risk - (storm, quake, flood, hail)
- Geographical diversification
- High parameter risk – uncertainty over the true value of expected losses

- Adverse Selection – Occurs when the insurer cannot distinguish between the probability of a loss for good and poor risk categories. If an average probability of loss is used to set a premium those at the highest risk will be the most likely to purchase coverage.
- Moral Hazard – Occurs when an insurer cannot predict the behaviour that will result from providing insurance coverage to an individual. An individual could act with less care, for example, and if data from uninsured individuals is used to estimate rates then premiums could be too low to cover losses.
- Correlated Risk – Occurs when there are many simultaneous losses from a single event – such as an earthquake.

b. Risks associated with investment activities that might affect the coverage of technical provisions (the amount set aside on the balance sheet to meet obligations arising out of insurance contracts including administrative expenses, embedded options, dividends to policyholders or bonuses and taxes) and/or solvency margins (capital), include:

- Market risk, also referred to as investment yield risk, relates to the ultimate amount of investment income that will be earned on the assets resulting from the investment (including reinvestments) that the insurance business makes. Since the income from assets provides an important part of the income needed to pay policyholder claims in longer term business, the risk of lower than expected returns makes an important claim on the insurer's surplus.
- Credit risk is the risk that the amounts due to the insurer may not be paid. The types of credit risks include:
 - *Asset credit risk* – the risk that the insurer will not receive a return or indeed a repayment of the capital on its investments due to the person receiving the investment failing to pay.
 - *Reinsurance credit risk* – the risk that the amounts to be paid by the reinsurer to the insurer under a reinsurance contract may not be fully collectible.
 - *Instalment payment risk* (including retrospective premiums) – the risk that the insured will not be able to pay the premium to the insurer.
- Concentration risk which may arise from the limited availability of suitable domestic investment vehicles.

c. Risks associated with risk management and reinsurance include:

- Basis Risk – an imperfect correlation between actual losses caused to the insurer and the payments received from a CAT bond.
- Intertemporal Basis Risk – the risk associated with changes in the book of business from the time when the model was used to price the policy.
- Retrocession risk – insurance on reinsurance – the transfer of ceded premiums to other reinsurers or primary insurers – creates credit risk and the possibility of a domino effect in the event of failure by the end reinsurer.

57. As well as the risks assumed as a result of performing functions relating to underwriting, investment and risk management as noted in the previous paragraph, an insurance enterprise is also exposed to other types of risk and to operational risk. Operational risk is the risk that a business may incur

liabilities in connection with its business activities. Operational risk includes liabilities arising from employees making errors in judgement, being negligent or careless, and conducting illegal or improper activities while acting within the scope of their employment. Recent examples (*e.g.* selling of products with a guaranteed rate of return that the insurance company cannot achieve in a low inflation environment) highlight the importance of managing this risk, as failure to do so can lead to the effective bankruptcy of the insurance enterprise.

58. Examples of other types of risk include:

- *Foreign exchange rate risk.* An international insurance company may have substantial foreign exchange rates risk. This is the risk that foreign exchange rates fluctuate compared to the balance sheet currency. Insurers generally seek to manage currency risk, including by using natural hedges, such as holding reserves and surplus in the currency of the jurisdiction in which the PE is located.
- *Liquidity risk* - the risk that assets need to be liquidated at unfavourable conditions if cash is needed immediately to meet unexpected obligations to policyholders. The latter risk is typically managed using an appropriate asset/liability management.
- *Reputation risk* – in many markets intermediaries serve as important distribution channels of insurance – an interface between consumers of insurance and providers of insurance. Their conduct may affect the insurer.
- *Some risks particular to the Life and Health Insurance lines:*
 - Asset default risk - the risk of loss resulting from on-balance sheet asset default and from contingencies in respect of off-balance sheet risks and related loss of income
 - Mortality and morbidity risk – the amount and timing of death and disability benefits paid
 - Longevity risk – increase in longevity increases the cash flow due to annuity payments
 - Persistency/lapse risk – if policyholders surrender their policies before prepaid (front end loaded) expenses are recovered – correlation with interest rates creates interest rate risk and market systematic risk
 - Cash flow risk – policies contain embedded options, *i.e.* to offset minimum interest payment guarantees, etc.
 - Guarantee and option risk - the risk of loss arising from guarantees and options embedded in policies, especially in segregated funds (variable or linked) policies.

ii) *Surplus Requirements / Solvency Margins*

59. As noted in Parts I-III, capital is an important condition for all enterprises, in particular those in the financial sector that accept and manage financial risks in the ordinary course of their business. In the context of insurance, the capital required in excess of the other liabilities and reserves in order to assume the risks described above is commonly referred to as surplus, and the surplus of assets over liabilities is commonly referred to as the solvency margin. Minimum levels of surplus are required by regulatory agencies based upon the lines of business of the insurer. Third parties doing business with the insurance enterprise would be concerned that the insurance enterprise will have sufficient financial resources to meet claims when they arise in the future. This is particularly important in the more long-term types of business, *e.g.* life insurance, where considerable periods of time might arise between the acceptance of the insured risk and the event triggering a claim.

iii) *Other Regulatory Requirements*

60. Regulators not only regulate the amount of surplus required to do insurance business, but also may regulate:

- the relative amounts or types of investments that can be made based upon the market risk of those investments and the lines of business conducted by the insurer and sometimes the pricing of contracts,
- the types of products or lines of business that can be sold,
- the amount and timing of the reserves that can be established to provide for future losses or claims,
- where there is specific host country regulation, this may also determine not just the amount of surplus, types of investment, etc. but also their location, *e.g.* by requiring specific assets to be held in the host country, and
- which particular reinsurance companies may be used in order for the ceding company to receive credit for premiums transferred.

61. In some jurisdictions, local insurance regulators require a foreign company to maintain assets in a local trust as a condition of conducting an insurance business in that jurisdiction. These “trusteed assets” generally must be sufficient in the regulators’ perspective to support the foreign company’s activities in that jurisdiction. Typically, the trusteed assets are equal in amount to the PE’s regulatory reserves and minimum surplus. The PE generally must obtain permission from insurance regulators to remove the trusteed assets and the trusteed assets may only be used to pay the PE’s liabilities. Thus, the trusteed assets are not available to pay other obligations of the foreign insurance company.

62. In some cases, a foreign insurance company reinsures insured risks in a country but is not licensed to do business in that country and may not have a PE in that country. Local insurance regulators may not allow a domestic company to claim credit (reduce regulatory reserves) for reinsurance purchased from the unlicensed foreign insurance company unless the foreign company places assets supporting the reinsurance contract in a trust fund. The trust fund typically holds assets at least equal to the amount of the regulatory reserves supporting the insured risks reinsured under the contract (see paragraph 19 above).

B-5. *Dependent Agent PEs*

63. Insurance companies sell insurance to customers through a number of different marketing channels (*i.e.* the internet, vending machines, telephone solicitation, etc.). Most insurance is sold through a broker or agent, though in the insurance industry the term “agent” sometimes means simply an employee of the insurance company as well as an agent proper, *i.e.* someone who is not an employee but who acts on behalf of the company with authority to conclude contracts in the name of the company. In some cases, the broker or agent may only sell policies issued by the company. Alternatively, a broker or agent may be paid on a commission basis and sell insurance policies of a number of different insurance companies. The activities of an insurance company in a foreign country may be limited to selling its products there through brokers or agents paid on a commission basis and complying with various regulatory requirements related to the policies sold (*i.e.* filing documents with the regulators and establishing trust funds in the country to hold insurance premiums).

64. An insurance company that sells insurance in a country through agents may have a PE in that country if the activities conducted by those agents fall within the definition of a “dependent agent” under Article 5(5) of the OECD Model Tax Convention. It should be stressed that the determination of whether an insurance company has a dependent agent PE for tax purposes is legally quite independent of whether the insurance company faces a licensing requirement for regulatory purposes, although to the extent that the criteria for identifying a dependent agent PE for tax purposes happen to overlap with the criteria for triggering a licensing obligation for regulatory purposes, there may be a practical connection. However, an insurance company that sells insurance through an agent of “independent status” would not be deemed to have a PE in that country through the agent’s activities provided it is “independent” within the meaning of Article 5(6) of the OECD Model Tax Convention. In short, an insurance company may engage in a large-scale business in a country but not have a PE because it sells insurance exclusively through “independent” agents under Article 5(6). See paragraph 39 of the OECD Model Commentary on Article 5. To obviate this possibility, some bilateral conventions include a provision that stipulates that insurance companies have a PE if they collect premiums in that country through an agent. Again see paragraph 39 of the OECD Model Commentary on Article 5. Discussion of the rules for determining whether an insurance company has a PE in a country through an agent is beyond the scope of this paper. The scope of this paper is limited to considering how much profit is attributable to a PE once a PE has been created through a dependent agent (dependent agent PE) or through a fixed place of business, as defined in Article 5 of the OECD Model Tax Convention.

65. Given the different types of activities that can be carried on through an agency PE, once it has been established that there is a dependent agent PE under Article 5(5), it will be essential to determine the exact functions performed by or through the dependent agent in order that profit can be appropriately attributed to that PE. In particular, a key question will be whether or not the PE is accepting insured risk, and assuming and managing the associated insurance risk, and therefore requires surplus to be attributed to it. This is discussed in detail in Section C-1(i)(d).

C. Applying the Authorised OECD Approach to Insurance Companies Operating Through PEs

66. This Section discusses how to apply the authorised OECD approach to attribute profits to a PE of an insurance enterprise. The approach taken is first of all to introduce the basic principles before describing in Section C-1 how the authorised OECD approach would apply generally to insurance businesses. Particular attention is paid to how the transfer pricing concepts of functional and comparability analyses, which are necessary to perform both the steps of the authorised OECD approach, can be applied, by analogy, to an insurance PE. Section C-2 discusses in detail how this general guidance would apply to specific situations commonly found in the insurance sector.

Basic principles used to attribute profits to a PE of an insurance company

67. For insurance, no less than for other businesses, the key aim is to attribute profits of an insurance enterprise to a PE in accordance with Article 7(2) of the OECD Model Tax Convention. In other words, it is necessary to determine “the profits which [the PE] might be expected to make if it were a distinct and separate enterprise engaged in the same or similar activities under the same or similar conditions”. A PE is not the same as a subsidiary since it is not in fact legally or economically separate from the rest of the enterprise of which it is a part. This is of course a natural outcome, resulting from the decision to operate through a PE rather than a subsidiary.

This section provides an introduction to the basic principles of the authorised OECD approach as applied to insurance PEs. The basic principles described below are discussed in more detail in the rest of the Report.

Functional and factual analysis

68. In the context of the authorised OECD approach, the functional and factual analysis is used to (1) delineate the PE as a hypothesised distinct and separate enterprise engaged in the same or similar activities under the same or similar conditions; and (2) to attribute profits to the PE under Article 7, using the guidance on the application of the arm's length principle of Article 9 given by the Guidelines, by applying these Guidelines by analogy and, where required, by adapting and supplementing these Guidelines to take into account factual differences between a PE and a legally distinct and separate enterprise. The functional and factual analysis will also take into account the assets used and risks assumed as a result of performing those functions. The functional and factual analysis will therefore have to identify the most important risks for the particular taxpayer and which functions give rise to those risks. Of particular importance will be the determination of the key entrepreneurial risk-taking functions of the enterprise and the extent to which the PE undertakes those functions. Generally, a key entrepreneurial risk-taking function is one which requires active decision-making with regard to the assumption and/or management (subsequent to the transfer) of the individual risks and portfolios of risks that have been identified as the most important under the functional and factual analysis. It is the key entrepreneurial risk-taking function that is likely to affect most directly the profitability of the insurance enterprise. This is because it is the performance of that function that leads to the assumption of the greatest risks and therefore the requirement for capital in the form of surplus. As explained further in Section C-1(v), the assumption of insurance risk is the key entrepreneurial risk-taking function for an insurance enterprise, and the management of that risk subsequent to its assumption generally does not involve the kind of active decision-making that justifies treating that management function as a key entrepreneurial risk-taking function. Accordingly, the balance of Part IV focuses on the assumption of insurance risk.

69. It should be stressed that an insurance business will have one key entrepreneurial risk-taking function, the assumption of insurance risk by performing the underwriting function described in Section B-2(i)(c). Various activities will contribute to that process, and their relative importance is likely to vary according to the particular facts and circumstances: *e.g.* product differences, type of business, business strategies, etc. Such activities require a key decision: what insured risks to accept and on what terms. Whether a given activity constitutes a part of the key entrepreneurial risk-taking function for a particular enterprise depends upon such factors as the type of insurance operation and the business model employed. As always the analysis depends on the facts and circumstances of the individual case.

70. The underwriting activity typically includes risk management functions related to setting the underwriting policy and the parameters for determining the amount of risk to underwrite. Such parameter-setting, without further involvement in assuming or managing the risk, would not generally be considered a function forming part of the key entrepreneurial risk-taking function of the assumption of insurance risk. This is consistent with the conclusion reached on similar activities performed in banking and global trading businesses (see Part II, paragraph 11 and Part III, paragraph 77). A contrary conclusion may be warranted if in the particular facts and circumstances the activity is more in the nature of operational than purely strategic parameter-setting, thus involving sufficiently active decision-making as to the acceptance of particular insured risks.

71. 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 (*i.e.* assets representing both reserves and surplus). Further, it will also be important to reward other functions in accordance with the arm's length principle. It should also be noted

that there is no presumption that these other functions are by nature of low value. This will be determined by the functional and comparability analyses based on the particular facts and circumstances. A whole spectrum of rewards from performing these other functions can be expected ranging from, at one end, low value rewards to at the other end rewards based on a share of the residual profit of the part of the enterprise acting as the key entrepreneurial risk-taker. In short, the functional and factual analysis determines the attribution of profits to the PE in accordance with its functions performed, assets used and risks assumed, and informs also the attribution of assets and investment income to the PE.

72. The functional and factual analysis is of critical importance. In attributing profits to a PE it is not sufficient to prepare symmetrically balanced books attributing profits in the books of the PE that correspond exactly to the values used in the books of the head office. Nor is it sufficient to record insured risks and the associated surplus, reserves and investment assets in the books without consideration of where the key entrepreneurial risk-taking function leading to their creation is performed. The extent to which taxpayers' accounting records and other contemporaneous documentation is to be given effect is described in Section B-3(v) of Part I of this Report (see in particular paragraph 39).

Attribution of investment assets and risks

73. Investment assets and related risks will be attributed to the PE in accordance with a functional and factual analysis of the enterprise concerned that, in particular, seeks to identify the key entrepreneurial risk-taking function relevant to determining the economic ownership of those assets. Unlike the banking industry, where the key entrepreneurial risk-taking function is the creation of (and subsequent management of the risks associated with) financial assets,³ the key entrepreneurial risk-taking function in the insurance industry is the assumption of insurance risk. It is the assumption of insurance risk that creates the need for an insurance enterprise to hold an amount of assets sufficient to support the reserves and surplus relevant to that risk. Accordingly, the economic ownership of investment assets of an insurance enterprise will be attributed to the part or parts of the enterprise that perform the function of assuming insurance risk, to the extent appropriate to support that risk.⁴ This is based upon the principles set forth in Part I of this Report, which require a determination of the assets used by the PE in its hypothesised status as a distinct and separate enterprise. The determination of where insurance risk is assumed should be made on a case-by-case basis as the activities comprising that key entrepreneurial risk-taking function and especially their relative importance will depend on the type of insurance business and its particular facts and circumstances. As noted in Part I, other assets and risks will be attributed to the PE in accordance with a functional and factual analysis that seeks to identify the significant people functions relevant to the economic ownership of assets and the significant people functions relevant to the assumption and/or management (subsequent to the transfer) of risks, except that the economic ownership of tangible assets will be attributed to their place of use in the absence of circumstances in a particular case that warrant a different view.

74. An insurance company earns income from holding investment assets (e.g. bonds and stocks). In general, investment assets are attributable to reserves (amounts set aside from premiums and investment returns to pay future claims and expenses) and surplus (amounts held in excess of reserves and other liabilities) held by the company. Thus, the amount of investment income includible in the taxable income arises from investment of assets representing both the reserves and surplus held by the company.

75. The authorised OECD approach must therefore provide guidance on how to determine the total amount of investment assets that need to be attributed to a PE in order to support the insurance risk assumed by that PE. Such assets are needed to fund both the reserves and surplus needs of the PE. One

³ See paragraph 51 of Part II.

⁴ See paragraph 22 of Part I which describes the consequences of attributing assets to a PE.

difficulty that presents itself in this regard is that there is no internationally accepted standard for determining either the amount of reserves to be established in respect of any particular pool of insured risks or the amount of surplus that should be maintained to absorb any losses or benefits in excess of the reserves. Countries' domestic law requirements for determining reserves and surplus vary widely, both from a regulatory and from a tax perspective. That being said, the different domestic law requirements tend to converge when it comes to the determination of the total amount of investment assets of insurance enterprises. This is the case, for example, because a jurisdiction with relatively high reserve requirements will tend to have relatively low surplus requirements compared to other jurisdictions in respect of comparable insurance enterprises. For this reason, the focus of the authorised OECD approach in the insurance industry is on determining the total amount of investment assets attributable to a PE in light of the insurance risk assumed by that PE, rather than on determining the separate reserves and surplus needs of the PE.

76. Parts I-III of this Report provide guidance for determining the extent to which a PE's activities are funded by "free" capital and interest-bearing debt for the primary purpose of being able to determine the interest deduction to which the PE may be entitled in calculating its taxable profit. Insurance enterprises typically do not have interest-bearing debt as a significant part of their capital structure, so it was not thought necessary to focus on the capital attribution approaches of Parts I-III in Part IV.

77. To some extent, the insurance industry corollary to other enterprises' capital structure based on "free" capital and interest-bearing debt is the distinction between surplus and reserves. The distinction can be relevant in determining taxable profits, because movements in reserves are typically taken into account in determining an insurance enterprise's taxable insurance income. It is worth noting, however, that countries' domestic law approaches to determining the relative proportions of reserves and surplus making up the capital structure of any particular insurance enterprise tend to vary much more than their approaches to determining debt versus "free" capital for other enterprises. There is no internationally agreed approach to determining particular ranges for the relative proportions of reserves and surplus making up the capital structure of insurance enterprises. For that reason, the question of the separate determination of reserves and surplus is regarded as one that is more appropriately left to the domestic law of the PE jurisdiction, and Part IV focuses instead on the attribution of total investment assets to the PE.

78. As described further below, different authorised approaches are identified as appropriate to determine the total investment assets attributable to a PE. These approaches, which bear some similarities to the approaches described in the other Parts of this Report for the attribution of "free" capital to a PE, are referred to as the "capital allocation approach" and the "thin capitalisation / adjusted regulatory minimum approach". They differ from those capital attribution approaches, however, in that their aim is to determine the total amount of investment assets attributable to a PE, not the extent to which those assets have been funded by "free" capital or debt, nor the extent to which they represent surplus or reserves.

79. That being said, it is important to bear in mind that the attribution of a total amount of investment assets to a PE under the authorised OECD approach is intended to reflect the total amount of such assets the PE would hold in order to fund its aggregate surplus and reserves needs, determined as if the PE were a distinct and separate enterprise operating at arm's length. Thus, it is useful to consider the relationship between that arm's length amount of total investment assets and regulatory requirements that may be applicable.

80. The amount of an insurance company's reserves is calculated based upon certain assumptions about estimated payouts, projected interest rates, and other assumptions with respect to revenue and expenses and includes a margin for adverse experience. In general, the assets of a company (including its investments) less its reserves for insured risks (or technical liabilities) and other liabilities will equal the surplus. Thus, the amount of the surplus held by a company is based on the methods used to record its

assets, calculate its reserves and record its other liabilities. The goal is to attribute the appropriate amount of investments and other assets to different parts of the enterprise (generally, equal to the reserves, liabilities and surplus of those parts of the enterprise).

81. The factual starting point for the attribution of investment assets to an insurance PE is that the assets representing surplus and reserves are primarily required to support the risks assumed by the enterprise. These assets must be regarded as following those risks. In other words, investment assets are to be attributed to a PE by reference to the insurance risk arising from its acceptance of insured risks, and not the other way round.

82. This attribution of investment assets to an insurance PE should be carried out in accordance with the arm's length principle, to ensure that the insurance PE, just like any other PE, has sufficient assets (to cover surplus and reserves) to support the functions it undertakes and, crucially, the risks it initially assumes and subsequently bears. Until such time as assets are called upon to meet any claims for which reserves have been established, to meet any excess of claims over reserves or to meet other liabilities they are invested and the income from these investments is attributed to the PE as described above. The Report describes a number of different possible approaches for applying that principle in practice, recognising that the attribution of investment assets to a PE is not an exact science, and that any particular facts and circumstances are likely to give rise to a range of arm's length results for the investment assets attributable to a PE, not a single figure. As noted earlier, the goal is to attribute the appropriate amount of investments and other assets to the PE (generally, equal to the reserves, liabilities and surplus of the PE).

83. The different possible approaches for attributing the total amount of investment assets needed to cover the surplus and reserves appropriate to the risk assumed by the PE all have their strengths and weaknesses in terms of how closely they approximate to the arm's length principle, the relative importance of which will depend on the circumstances. The key to attributing an appropriate amount of total investment assets is to recognise:

- the existence of the strengths and weaknesses in any approach, and when these are likely to be present;
- that the key test of the suitability of an approach in any particular case is whether it results in an attribution of total assets (covering reserves and surplus) that is consistent with the arm's length principle. It may well be appropriate to test this by applying one of the other approaches, to see whether this produces an outcome within a similar range.

Recognition of dealings

84. There are a number of aspects to the recognition (or not) of dealings between a PE and the rest of the enterprise of which it is a part. First, a PE is not the same as a subsidiary, and it is not in fact legally or economically separate from the rest of the enterprise of which it is a part. It follows that:

- all parts of an insurance enterprise have the same creditworthiness, except where due to host country regulation certain assets are held as trustee assets and so can only be used to meet claims in the host country. This means that dealings between a PE and the rest of the enterprise of which it is a part should generally be priced on the basis that both share the same creditworthiness; and
- there is no scope for the rest of the enterprise guaranteeing the PE's creditworthiness, or for the PE to guarantee the creditworthiness of the rest of the enterprise of which it is a part.

85. Second, dealings between a PE and the rest of the enterprise of which it is a part have no legal consequences for the enterprise as a whole. This implies a need for greater scrutiny of dealings between a PE and the rest of the enterprise of which it is a part than of transactions between two associated enterprises. This also implies a greater scrutiny of documentation (in the inevitable absence, for example, of legally binding contracts) that might otherwise exist and considering the uniqueness of this issue, countries would wish to require taxpayers to demonstrate clearly that it would be appropriate to recognise the dealing.

86. This greater scrutiny means a threshold needs to be passed before a dealing is accepted as equivalent to a transaction that would have taken place between independent enterprises acting at arm's length. Only once that threshold is passed can a dealing be reflected in the attribution of profits under Article 7(2). The functional and factual analysis must determine whether a real and identifiable event has occurred and should be taken into account as a dealing of economic significance between the PE and another part of the enterprise.

87. Thus, for example, an accounting record and contemporaneous documentation showing a dealing that transfers economically significant risks, responsibilities and benefits would be a useful starting point for the purposes of attributing profits. Taxpayers are encouraged to prepare such documentation, as it may reduce substantially the potential for controversies regarding application of the authorised OECD approach. Tax administrations would give effect to such documentation, notwithstanding its lack of legal effect, to the extent that:

- the documentation is consistent with the economic substance of the activities taking place within the enterprise as revealed by the functional and factual analysis;
- 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; and
- the dealing presented in the taxpayer's documentation does not violate the principles of the authorised OECD approach by, for example, purporting to transfer risks in a way that segregates them from functions.

See paragraphs 1.26-1.29 and 1.36-1.41 of the Guidelines by analogy. See also Section C-1(v) of this Part IV regarding internal reinsurance.

88. It is important to note, however, that the authorised OECD approach is generally not intended to impose more burdensome documentation requirements in connection with intra enterprise dealings than apply to transactions between associated enterprises. Moreover, as in the case of transfer pricing documentation under the Guidelines, the requirements should not be applied in such a way as to impose on taxpayers costs and burdens disproportionate to the circumstances.

89. Third, where dealings are established and are capable of being recognised, they should be priced on an arm's length basis, assuming the PE and the rest of the enterprise of which it is a part to be independent of one another. This should be done by analogy with the Guidelines, following a functional and factual analysis.

Attribution of profits

90. The attribution of profits to an insurance PE on an arm's length basis will follow from the calculation of the profits (or losses) from all its activities, including transactions with other unrelated

enterprises, transactions with related enterprises (with direct application of the Guidelines) and dealings with other parts of the enterprise (under step 2 of the authorised OECD approach). This analysis involves the following two steps:

Step One

A functional and factual analysis, leading to:

- The attribution to the PE as appropriate of the rights and obligations arising out of transactions between the enterprise of which the PE is a part and separate enterprises;
- The identification of the functions forming part of the key entrepreneurial risk-taking function relevant to the assumption of insurance risk and the attribution of that risk to the PE;
- The determination of the appropriate amount of investment assets required to support the insurance risk assumed by the PE and the attribution of those assets to the PE (see paragraphs 123 ff. below);
- The identification of significant people functions relevant to the assumption of other risks, and the attribution of those risks to the PE;
- The identification of significant people functions relevant to the attribution of economic ownership of other assets, and the attribution of economic ownership of those assets to the PE;
- The identification of other functions of the PE; and
- The recognition and determination of the nature of those dealings between the PE and other parts of the same enterprise that can be appropriately recognised, having passed the threshold test.

Step Two

The pricing on an arm's length basis of recognised dealings through:

- The determination of comparability between the dealings and uncontrolled transactions, established by applying the Guidelines' comparability factors directly (characteristics of property or services, economic circumstances and business strategies) or by analogy (functional analysis, contractual terms) in light of the particular factual circumstances of the PE; and
- Applying by analogy one of the Guidelines' traditional transactions methods, or, where such methods cannot be applied reliably, one of the transactional profit methods to arrive at an arm's length compensation for the dealings between the PE and the rest of the enterprise, taking into account the functions performed by and the assets and risks attributed to the PE

The pricing on an arm's length basis of any transactions with associated enterprises attributed to the PE should follow the guidance in the Guidelines and is not discussed in this Report. The order of the listing of items within each of the steps above is not meant to be prescriptive, as the various items may be interrelated.

The resulting determination of the profits attributable to the PE reflects both its income and expense from recognised dealings in amounts equal to an arm's length compensation for the functions that the PE and the rest of the enterprise of which it is a part respectively perform, taking into account the assets and risks attributed to the PE and the other parts of the enterprise.

91. The guidance in the Guidelines can be applied by analogy in order to attribute profit to the PE on an arm's length basis, taking into account the principles outlined in the previous paragraph.

C-1. First Step: Determining the Activities and Conditions of the Hypothesised Distinct and Separate Enterprise

i) Attributing Functions, Assets and Risks to the PE

a) General

92. It is necessary under the first step of the authorised OECD approach to hypothesise the PE as a distinct and separate enterprise “engaged in the same or similar activities under the same or similar conditions”. This entails the performance of a functional and factual analysis, conducted in accordance with the guidance found in the Guidelines, in order to appropriately hypothesise the PE and the remainder of the enterprise (or a segment or segments thereof) as if they were associated enterprises, each undertaking functions, owning and/or using assets, assuming risks (and liabilities) and entering into dealings with each other and transactions with other related and unrelated enterprises. As explained in Part I of this Report (see Sections B-3 and D-2), the functional and factual analysis performed in the first step must identify the economically significant activities and responsibilities undertaken by the PE. This analysis should, to the extent relevant, consider the PE’s activities and responsibilities in the context of the activities and responsibilities undertaken by the enterprise as a whole, particularly those parts of the enterprise that engage in dealings with the PE. Ideally, book entries will be consistent with, and follow from, the functional and factual analysis. Where this is in fact the case, the accounts or books of the PE will be a useful starting point for determining the profits attributable to the PE. For example, while taxpayers may show insured risks in the books of a particular jurisdiction, the results of such booking practices should not be respected where they are inconsistent with the functional and factual analysis, such as where the booking location does not perform the key entrepreneurial risk-taking function in respect of the insured risks.

93. Section B above provides a brief general functional analysis of insurance operations which should assist in carrying out the functional and factual analysis of an insurance enterprise. Of particular importance in a PE context is the conclusion that the determination of the key entrepreneurial risk-taking function for a particular business is a matter of facts and circumstances. All facts and circumstances need to be considered to determine which function assumes insurance risk for the enterprise, because the assumption of insurance risk is the key entrepreneurial risk-taking function for an insurance enterprise. Other functions performed by an insurance enterprise may be important and valuable functions and should be compensated accordingly, but these other functions are not functions that form part of the key entrepreneurial risk-taking function.

94. 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. As described in Section C-1(i)(b) below (relating to split functions), special consideration may need to be given to cases where the activities

constituting the key entrepreneurial risk-taking function of assuming insurance risk are carried out in more than one location.

Impact of regulation

95. One question that arises is the extent to which regulation determines where the insurance risk is assumed and managed. Consider the following example where the host state (State A) requires the PE of the insurance enterprise to have a licence to conduct insurance business, to hold assets in State A to cover the risks from the policies written under that licence and to show those assets and liabilities on the balance sheet of the PE. Does it therefore automatically follow that the PE in State A should be treated as assuming and managing the insurance risk even if in fact all the necessary functions are carried out in the head office and not in State A?

96. The answer is that regulation of itself is not the sole determinant of where insurance risk is assumed and managed as the authorised OECD approach ultimately looks to the functional and factual analysis to determine such matters. The position taken under host state regulation would be the starting point of the functional and factual analysis and there would be a presumption that it reflects the actual position. In many cases, there will be a convergence between this presumption and what actually happens because of the impact of regulation on the functions that are likely to be performed by the PE. However, this is a rebuttable presumption and the position taken by the regulator would not be followed if it were found to be inconsistent with the functional and factual analysis.

97. One good reason for treating the position taken by the regulator as persuasive but not determinative is the fact that often there is no host state regulation (*e.g.* where both home state and host state are within the European Union) or sometimes any regulation at all (*e.g.* for reinsurance). In such cases, the starting point would be the properly drawn up books and records of the PE and again as noted in paragraphs 87-88 these would be followed provided they accurately reflect the functional and factual analysis.

98. 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 the PE.

99. As well as analysing each of the functions performed by the PE in detail, it is also necessary to consider what assets are used and risks assumed in performing those functions. In terms of assets used, the most important assets have been identified in Section B-3 above. As noted above (see paragraphs 73-83), investment assets will have to be attributed to the PE to the extent necessary to meet the reserves and surplus needs created by the PE's assumption of insurance risk. Further guidance on the attribution of investment assets to a PE is provided in Section C-1(iii) below. With respect to non-investment assets, there are no problems particular to insurance which require guidance beyond that found in Section C-3(iv)(b) of Part I.

100. In terms of risks assumed, the guidance in Part I should be followed. In particular, as noted in paragraph 99 of Part I, "to the extent that risks are found to have been assumed by the enterprise as a result of a significant people function relevant to the assumption of those risks being performed by the PE, the assumption of those risks should be taken into account when attributing profit to the PE performing that function." This raises the question of what functions of an insurance business lead to the assumption of particular types of risk. In terms of risk assumed, it is the performance of the key entrepreneurial risk-taking function that leads to the assumption of insurance risk. Consequently, it is the undertaking of the key entrepreneurial risk-taking function that creates the possibility of significant profit or loss from

insurance risk and the need for surplus and reserves in relation to that risk. Other types of risks may be attributed to a PE based on the performance there of significant people functions relevant to the assumption of those risks, as explained in Part I, and the PE will require surplus to support those risks as well.

101. Having appropriately determined the functions performed, the assets used and the risks assumed by the PE, the next question is how to attribute profit in respect of those functions. For insurance, a key part of an insurance company's profits is the income from its investment assets. The authorised OECD approach is to attribute the investment assets (and therefore the associated income and expenses) to the PE that performs the key entrepreneurial risk-taking function of the insurance business (*i.e.* the assumption of insurance risk), as required to cover the surplus and reserves needs created by the assumption of that risk. This will give the PE to which such assets are attributed (the "economic owner") the income from the investment assets attributed to it, *e.g.* the investment income from a government bond.

102. The profit attributed will also take into account any dealings at arm's length to reward other parts of the enterprise for functions performed, *e.g.* for marketing the insurance product and introducing the customer, use of valuable intangibles, management of the investment assets, etc.

103. As noted in Part II of this Report, the part of a banking enterprise performing the sales/trading function would be attributed the financial asset created by the performance of that function (*e.g.* the loan) where this function was found to be the key entrepreneurial risk-taking function in respect of the creation of that asset and would also have attributed to it the capital supporting that asset. In the insurance business, the key entrepreneurial risk-taking function is not the creation of an asset (*e.g.* a loan) but is instead the assumption of a potential liability (*i.e.* the assumption of insurance risk) for compensation (*i.e.* a portion of the premium). It is the performance of that function that creates the need for surplus and reserves appropriate to the level of insurance risk assumed and hence the need for investment assets to cover that amount of surplus and reserves. Thus, that amount of investment assets, along with the associated income and expense, is attributed under the authorised OECD approach to the PE that has assumed the relevant insurance risk.

104. It is necessary to identify which functions form part of the key entrepreneurial risk-taking function of assuming insurance risk and whether such functions accordingly require surplus and reserves to support their performance and the assumption of associated insurance risk. The assumption of insurance risk by a PE requires the attribution to that PE of the economic ownership of investment assets sufficient to cover the surplus and reserves necessary to support that risk. The economic ownership of investments has a *prima facie* link with market risk (or investment yield risk), which suggests that surplus for that risk should be attributed to the PE to which the investments are attributed, even if this location is different from the location that performs the investment management function. The marketplace and regulators appear to require the maintenance of surplus in respect of the other types of risks as well. It follows that the assumption of those risks also requires surplus. A more difficult question is which part of the enterprise assumes any of the risks. In making that determination, it is acknowledged that a PE may perform certain functions without assuming the associated risks where the functions are performed as a service to another PE (which assumes the associated risks) under a dealing that the taxpayer is able to establish between the two PEs and that is recognised. In such circumstances, the PE performing the services would be compensated by the other PE on normal transfer pricing principles.

105. The assets and liabilities recorded in the accounts and books of the PE form a practical starting point for determining whether the economic ownership of assets and risks have been assigned to the location where the key entrepreneurial risk-taking function was performed. The accounts and books should be respected for tax purposes, provided they reflect an attribution of assets and risks that is consistent with the functional and factual analysis (including any dealings). If a material amount of assets and risks are

booked in a PE even when the PE does not perform the key entrepreneurial risk-taking function, then respecting the booking location in such cases would not lead to an arm's length attribution of profits.

106. This is why the theoretical basis of the authorised OECD approach is that assets and risks are attributed by reference to a functional and factual analysis, especially the identification of the key entrepreneurial risk-taking function. Following the aggregation principle of the Guidelines (see paragraph 1.42) this analysis may be performed at the level of portfolios of similar assets and risks, rather than for each individual asset and risk.

b) Split functions

107. Where the functional analysis has determined that the PE alone has performed the key entrepreneurial risk-taking function, the PE will be attributed the newly created insurance risk, together with the associated underwriting income and investment income from the assets required as surplus and reserves to support the insurance risk. Tax issues will arise where all functions relevant to the acceptance of a particular insured risk are not performed in the same location. The part or parts of the enterprise performing the key entrepreneurial risk-taking function are the “economic owners” of the underwriting income and investment income associated with the performance of that function. “Economic ownership” of insurance contracts is not split unless the key entrepreneurial risk-taking function is performed in more than one location.

108. Where the functional analysis shows that the functions forming part of the key entrepreneurial risk-taking function leading to the assumption of insurance risk have been performed in more than one location, that insurance risk can be considered as economically owned jointly. The relative value of those functions performed in the different parts of the enterprise will be used to attribute the insurance risk and the associated underwriting and investment income from financial assets. For example, if it were determined that 60% of the value of the key entrepreneurial risk-taking function was performed in the PE and 40% in the head office, the insurance risk and associated underwriting and investment income would similarly be attributed 60% to the PE and 40% to the head office. The guidance in the Guidelines will be applied, by analogy, in order to determine the relative value of the functions forming part of the key entrepreneurial risk-taking function performed in the different parts of the enterprise. Again, following the aggregation principle of paragraph 1.42 of the Guidelines, the analysis may be made at the portfolio or book level of similar assets and risks, rather than for each individual financial asset or risk.

c) Indirect benefits provided by sales PEs

109. A particular situation found in insurance is that in some instances an insurer may operate in a country in a number of ways. It may have a permanent establishment as a result of a fixed place of business under Article 5(1) of the OECD Model Tax Convention, but it may also have agent(s) or subsidiaries carrying out business in that location. The question arises as to how such a structure will affect the profit to be attributed to the permanent establishment.

110. For example, look at the situation where the enterprise operates in country A through a permanent establishment and also through independent sales agents. A PE may only deal with a limited range of products, and the independent agents may be selling other products which are run and managed by the head office or other PEs. In this case it would not be appropriate to attribute the sales and marketing function and the risk underwriting function of contracts entered into by the independent agents to the permanent establishment, and to attribute relevant costs such as commission to the PE, as the permanent establishment is functionally not involved with the contracts sold by the independent agents. This demonstrates that there is no “force of attraction” element in the authorised OECD approach – we cannot

say that just because an enterprise has a permanent establishment in a country, the PE will have the risks and rewards of all activity carried out there.

111. However, it will also be important to further examine whether the permanent establishment is in practice performing some services which need to be rewarded. The permanent establishment may have engaged in a major advertising campaign designed to raise the profile of the insurer and its brand name. This may well be enhancing the sales by the agents, and the profits of these sales can be attributed to the head office. It would then be a matter of applying the Guidelines to the particular situation. The Guidelines would determine whether any benefit to the head office was purely incidental to the benefit to the PE, whether the PE would be treated as providing a service of promoting the insurer's brand name and product image, or whether the PE would be treated as the "economic owner" of a new or developed intangible.

112. The same general approach is needed where the PE may be directly or indirectly benefiting a subsidiary of the entity operating in the same country. It is a general transfer pricing issue as to whether charges should be imposed in respect of services rendered in either direction and the guidance in Chapters VII and VIII of the Guidelines should be followed by analogy for insurance PEs.

d) Dependent agent PEs

113. As indicated in Section D-5 in Part I, this Report does not examine the issue of whether a PE exists under Article 5(5) of the Model Tax Convention (a "dependent agent PE")⁵ but discusses the consequences of finding that a dependent agent PE exists in terms of the profits that should be attributed to the dependent agent PE. It is worth emphasising at the outset that the discussion below is not predicated on any lowering of the threshold of what constitutes a PE under Article 5. Also, even if tax and regulatory standards may provide similar prerequisites for constituting a PE, the determination for both standards needs to be performed independently, and a finding of a PE under one standard should not affect the other except to the extent that the prerequisites actually overlap. It is a fact that some of the functions associated with an insurance business are commonly undertaken by dependent agents within the meaning of Article 5(5). For example, an insurance company may employ one or more dedicated brokers ("dependent agent enterprise") to market their policies within the host jurisdiction and may give that broker authority to bind the insurance company with respect to those policies. General guidance on the attribution of profits to dependent agent PEs is contained in Section D-5(ii) of Part I and this section applies that guidance to the specific factual situation of cross-border insurance.

114. In cases where a PE arises from the activities of a dependent agent, the host jurisdiction will have taxing rights over two different legal entities - the dependent agent enterprise (which may be a resident of the PE jurisdiction) and the dependent agent PE (which is a PE of a non-resident enterprise). In respect of transactions between the associated enterprises (the dependent agent enterprise and the non-resident enterprise), Article 9 will be the relevant article in determining whether the transactions between the associated enterprises were conducted on an arm's length basis.

115. In respect of the dependent agent PE, the issue to be addressed is one of determining the profits of the non-resident enterprise which are attributable to its dependent agent PE in the host country (*i.e.* as a result of activities carried out by the dependent agent enterprise on the non-resident enterprise's behalf). In this situation, Article 7 will be the relevant article. Finally, it is worth stressing that the host country can

⁵ Some tax conventions between OECD members contain a special provision that deems an insurance company to have a PE when the company insures a risk situated in that country through an agent of independent status. See paragraph 39 of the Commentary on Article 5 of the OECD Model Tax Convention. The principles discussed in this Report would apply to attribute profits to these types of PEs.

only tax the profits of the non-resident insurance company where the functions in the host country performed on behalf of the non-resident enterprise exceed the PE threshold as defined under Article 5. Further, the quantum of that profit is limited to the business profits attributable to the insurance functions performed through the PE in the host country.

116. Where a dependent agent PE is found to exist under Article 5(5), the question arises as to how to attribute profits to the PE. The answer is to follow the same principles as used for other types of PEs for to do otherwise would be inconsistent with Article 7 and the arm's length principle. Under the first step of the authorised OECD approach a functional and factual analysis determines the functions undertaken by the dependent agent enterprise both on its own account and on behalf of the non-resident enterprise. On the one hand, the dependent agent enterprise will be rewarded for the services it provides to the non-resident enterprise (taking into account its assets and its risks, if any) usually by means of a fee from the non-resident enterprise.

117. On the other hand, the dependent agent PE will have attributed to it the assets and risks of the non-resident enterprise relating to the functions performed by the dependent agent enterprise on behalf of the non-resident enterprise, including a sufficient amount of investment assets to cover the reserves and surplus required to support risks. The authorised OECD approach then attributes profits to the dependent agent PE on the basis of those assets and risks. The analysis focuses on the nature of the functions carried out by the dependent agent on behalf of the non-resident enterprise and in particular whether it undertakes the key entrepreneurial risk-taking function. In this regard an analysis of the skills and expertise of the employees of the dependent agent enterprise is likely to be instructive, for example in determining whether underwriting or negotiating functions are being performed by the dependent agent on behalf of the non-resident enterprise. The collection of premiums does not mean that the dependent agent PE is accepting the insured risk, if the decision to accept the risks associated with the insurance policy is not made by the dependent agent.

118. In calculating the profits attributable to the dependent agent PE, it would be necessary to determine and deduct an arm's length reward to the dependent agent enterprise for the services it provides to the non-resident enterprise (taking into account its assets and its risks, if any). Issues arise as to whether there would remain any profits to be attributed to the dependent agent PE after an arm's length reward has been given to the dependent agent enterprise. In accordance with the principles outlined above, the answer is that it depends on the precise facts and circumstances as revealed by the functional and factual analysis of the dependent agent and the non-resident enterprise. However, the authorised OECD approach recognises that it is possible in appropriate circumstances for such profits to be attributed to the dependent agent PE.

119. However, a functional and factual analysis of a transaction may show that the risks arising from the transaction are being assumed by the dependent agent enterprise for the account of its principal, *i.e.* the non-resident enterprise in whose books the transaction - and the resultant risk - appears. These risks, and therefore the assets needed to support them, will be attributed to the dependent agent PE to the extent that they arise from functions performed by the dependent agent in the host country on behalf of the non-resident enterprise. In short, when attributing profits to the dependent agent PE, there are likely to be profits (or losses) over and above the arm's length service fee paid to the dependent agent enterprise. This is particularly true in the case of insurance as the assumption of risk, and the corresponding need to maintain both reserves and surplus to provide a cushion against the realisation of losses from those risks, is fundamental to the business.

120. In addition to selling insurance through a dependent agent, a company may also sell insurance through agents of "independent status", the activities of which generally will not constitute a PE. Thus, an insurance company may have PEs resulting from the activities of some agents (dependent agents) but not

other agents (independent agents) selling insurance in the same country. In these cases, independent agents may derive substantial benefits from a PE (arising either from a fixed place of business or from a dependent agent) located in the same jurisdiction. For example, independent agents may only be able to sell insurance of a company because a PE has obtained a license to sell insurance in that jurisdiction. The PE may also be engaging in activities that indirectly support insurance sales made by the independent agents such as marketing activities and ensuring that the company's policies comply with tax and regulatory requirements. Accordingly, the functional analysis must consider the functions performed, assets used and risks assumed through the fixed place of business or dependent agents that benefit the business conducted through independent agents. See discussion in Section C-1(i)(c) above.

121. The PE should receive appropriate compensation for performing these functions, either directly from the independent agent (adjusted, if necessary, to an arm's length reward where the independent agent is an associated enterprise) or indirectly, from the part of the enterprise that benefits from the activities of the independent agents. In the latter case, the compensation should be determined under the same principles that are discussed below in the second step of the authorised OECD approach described in Section C-2.

ii) Attributing Creditworthiness / Solvency Margin to the PE

122. For similar reasons as stated for banks in Part II of this Report, the starting point of the authorised OECD approach is generally to attribute the same creditworthiness or solvency margin to the PE as enjoyed by the insurance enterprise as a whole. Third parties doing business with the PE would assume that all the assets of the enterprise would be available to support its insurance liabilities. However, in the insurance industry there may be cases where because of regulatory or other restrictions (see discussion on "trusteed" assets at paragraphs 61-62) this is often not the case in a particular jurisdiction and so the creditworthiness or solvency margin of the PE may need to be determined on a "stand-alone" basis taking into account the regulatory and other restrictions in that jurisdiction and other jurisdictions. In such cases, it will be necessary to determine the creditworthiness of the PE, for example by reference to independent enterprises in the host country that are comparable in terms of assets, risks, management, etc. or by reference to objective benchmarks such as evaluations of creditworthiness from independent parties that evaluate the PE based on its facts and circumstances and without reference to the enterprise of which it is a part.

iii) Attributing Investment Income / Assets to the PE

123. Section B-2(i) described the importance of investment income for an insurance company. That investment income arises largely due to the investment of the surplus and reserves that are required (by regulators, the marketplace, the rating agencies or good business practice) in order to undertake insurance business. In order to arrive at an arm's length attribution of taxable profits to an insurance PE, it is therefore vital to ensure an appropriate attribution to the PE of investment assets resulting from the investment of surplus and reserves required to appropriately cover the risks attributed to the PE. Taking this special relationship between risks and investment assets into account, this section considers how to determine the arm's length amount of investment assets that should be attributed to the PE.

a) General overview

124. As described in Section B-2(i), the acceptance of insured risks leads to the assumption of underwriting or insurance risk, *i.e.* the potential for the amount (or timing of) actual claims and expenses to exceed (or differ from) the amount (or timing) of expected claims and expenses. This underwriting risk

(along with the other types of risk described in Section B-4(i)) can only be assumed if reserves are established to meet the potential claims and there is surplus available to provide a cushion in the event that reserves are insufficient to meet claims. Thus, an insurance enterprise must have sufficient assets to cover both its reserves and surplus requirements.

125. The question arises as to what is the effect of attributing reserves and surplus to a PE. As described in Section B-1(i), in the insurance business, the acceptance of insured risks results in the creation of liabilities in the form of reserves representing the future claims of the insureds. Assets used to back those liabilities (in the form of reserves) obtain a return (referred to as investment income) which may help to pay the future claims. Assets representing the surplus also obtain an investment return, which may be used to pay out claims, in the case where underwriting or investment risks have been realised and reserves are insufficient, or to increase surplus through an increase in profit. Thus, the investment return from both the reserves and surplus is part of the “investment income” attributable to an insurance business, and therefore, an essential component in determining the taxable income of the business.

126. How then can the authorised OECD approach be applied to insurance business and the investment return derived from it? The authorised OECD approach requires that a PE of an insurance company be hypothesised as a distinct and separate enterprise from the enterprise of which it is a part. There must then be attributed to the PE the total investment assets that it would have if it were a distinct and separate enterprise carrying on the same activities and incurring the same risks (*i.e.* an amount of investment assets sufficient to cover the reserves and surplus appropriate to the level of insurance risk assumed by the PE).

127. Parts I through III of this Report determine the assets attributable to a PE through a functional and factual analysis that seeks to identify the significant people functions relevant to the determination of the economic ownership of assets (in the case of assets other than financial assets of a financial enterprise) or the key entrepreneurial risk-taking functions (in the case of financial assets of a financial enterprise). They then focus on the extent to which those assets are funded either by “free” capital or by debt. The application of the authorised OECD approach to the insurance industry requires a slightly different focus, though one based on the same fundamental principles. For insurance enterprises, the key entrepreneurial risk-taking function is the assumption of insurance risk, which itself creates the need for the maintenance of an adequate pool of assets to support that risk.

128. As explained above (see paragraphs 73-83), the authorised OECD approach must therefore provide guidance on how to determine the total amount of investment assets that need to be attributed to a PE in order to support the insurance risk assumed by that PE. The goal of this guidance is to reflect the total amount of such assets the PE would hold in order to fund its aggregate surplus and reserves needs, determined as if the PE were a distinct and separate enterprise operating at arm’s length. Whilst the authorised approaches that have been developed for attributing total investment assets to the PE (*i.e.* the “capital allocation approach” and the “thin capitalisation / adjusted regulatory minimum approach”, described further below) are not intended to determine separately the portion of the PE’s investment assets reflecting its reserves and surplus, the link between total investment assets and total reserves and surplus must not be forgotten.

129. For example, in considering how the authorised OECD approach may apply to determine what reserves and surplus and therefore what investment income and gains are attributable to a PE, it must be appreciated that a company will not be able to carry on business if it holds merely the minimum amount of surplus required by regulators. Those placing business with insurers are heavily influenced by a company’s financial strength – particularly in life and other long-term business where the policyholder needs assurance not only that the company is in a position to meet its liabilities at the time the policy is taken out but also that it is likely still to be in business and able to meet its liabilities many years or decades later.

This means that to attribute to a PE only an amount of investment assets adequate to cover its reserves and the minimum regulatory surplus may not produce arm's length results.

130. Two authorised approaches to allocating total investment assets have been chosen: (1) capital allocation, and (2) thin capitalisation / adjusted regulatory minimum, although a third approach — quasi thin capitalisation / regulatory minimum — can be applied albeit only as a domestic law safe harbour. The rest of this section examines the strengths and weaknesses of the authorised approaches to attributing a total amount of investment assets to an insurance PE.

b) Capital allocation approach

131. There are two principles that underlie the allocation of investment assets to the PE under the capital allocation approach. First, that the investment assets of an insurance business support all of its business, without regard to where such business is conducted (see paragraph 140 below for discussion of an exception to this rule). Second, that all of the investment assets of the entire business must be attributed to the various parts of the business, and accordingly, the sum of the attributable investment assets will be neither more nor less than the total investment assets belonging to the business as a whole. The amount of investment assets to be allocated under the authorised OECD approach is the actual amount of investment assets of the insurance enterprise. The investment assets support the insurance risk assumed by the enterprise as a whole and allocation should be made in proportion to the insurance risk assumed by each part of the enterprise. However, the above principles do not always apply to all insurance enterprises. As noted in paragraphs 61-62, in some jurisdictions the host country regulatory rules will mean that assets (“trusteed assets”) are only available to meet claims in the host country jurisdiction and so the capital of the insurance enterprise is in fact segregated to some extent.

132. It will be necessary to properly allocate the total investment assets of the enterprise and not just the amount of assets representing the regulatory minimum of reserves and surplus, if capital allocation approaches are to be used as a proxy for the application of the arm's length principle. This is on the basis that all the risks have been attributed to the various parts of the enterprise, including the head office, under the functional analysis. Given a functionally based attribution of risks, there is no reason to attribute part of the investment assets to the head office simply on the basis that the head office would be expected to absorb any extraordinary and unforeseeable losses arising from the realisation of risks. Instead, this determination would be based on the functional analysis.

133. However, Article 7(2) requires that the PE be regarded as a distinct and separate enterprise from the enterprise of which it forms part. It might therefore be argued that, as a distinct and separate enterprise, the PE and the rest of the enterprise would require more investment assets to support activities than is actually the case in operating as one larger enterprise. The reason would be that an insurance enterprise pools the risks incurred in each of its parts and thus, in terms of requirement of reserves and surplus to meet claims, it benefits from spreading such risk across a wider range of potential claims.

134. However, Article 7(2) also requires that the PE be hypothesised, as a distinct and separate enterprise from the enterprise of which it forms part, but performing the same or similar functions under the same or similar conditions. The advantage of pooling should thus be attributed to each of the hypothesised distinct and separate enterprises (*i.e.* the PE and the rest of the enterprise), so that the reserves and surplus (and hence investment asset) requirements of each are reduced to those of the actual overall legal enterprise. The concept might best be understood if the two hypothesised distinct and separate enterprises are treated as having entered a risk pooling agreement which reduces their total need for

investment assets. Where such agreements exist between actual separate legal enterprises, neither party has a claim to the reduction in reserves and surplus and this result should be reflected when applying the Guidelines by analogy. That is, the investment assets to be allocated to the different parts of the overall legal entity are the actual investment assets held by the entity and not a hypothetical amount.

135. This raises an important question of whether there are internationally accepted risk-based regulatory standards that could be adapted so as to approximate an arm's length attribution of investment assets to parts of an insurance business in most situations. All OECD member countries regulate insurance business and set minimum asset and surplus requirements for insurance companies regulated in their jurisdiction. However, in insurance there is not an internationally accepted standard as exists in banking where the Basel Accord plays an important part in setting global standards. Each jurisdiction sets its own standards, though in the European Economic Area there is a single approach set out in the Insurance Directives. However, even in those states where the regulator requires a minimum amount of assets to be allocated to a PE, this amount may not approximate an arm's length allocation. Also it may be that assets are required to be held by the PE for regulatory reasons even though the PE has not undertaken any of the functions leading to the assumption and management of insured risk and so would not be attributed those assets under the authorised OECD approach.

136. In applying the capital allocation approach, it is necessary to consider the treatment of trustee assets, as described in Section B-4. To the extent that such assets may not be used to support activities outside the jurisdiction in which the trusts are located, the factual premise underlying the capital allocation approach would be violated. Several points are worth noting in relation to the implications of trustee assets for the use of the capital allocation approach to attributing an arm's length amount of investment assets to the PE.

137. First, the use of the capital allocation approach is intended only to attribute a total amount of investment assets to the PE based on the risk it has assumed, not to identify specific assets to be so attributed. The determination of the specific assets to be considered attributable to the PE is discussed below in the context of determining the PE's yield on its investment assets. Thus, the fact that some assets of the enterprise may be trustee in another location does not necessarily mean that they are irrelevant to the determination of the total investment assets of the enterprise relative to its total risks (*i.e.* one step in the capital allocation approach).

138. Second, the focus of the authorised OECD approach on locating the performance of the key entrepreneurial risk-taking function of assuming insurance risk means that in some circumstances there may be a difference between the location where such risk is considered assumed for tax purposes and the location where it is booked for regulatory purposes. Whilst such differences are not expected to arise commonly, they do illustrate why the attribution of investment assets to a PE under the authorised OECD approach cannot be totally dependent on the regulatory requirements to hold certain amounts of trustee assets in particular locations. For example, the fact that investment assets may be trustee in the PE country does not necessarily mean that that amount of assets should be attributed to the PE under the capital allocation approach if that allocation does not represent an arm's length allocation appropriate to the level of risk assumed by the PE (*e.g.* as may be the case if the key entrepreneurial risk-taking function of assuming the risk which those assets support was performed elsewhere).

139. Similarly, if the key entrepreneurial risk-taking function of assuming risk is performed in the PE jurisdiction, the absence of any regulatory requirement to hold trustee assets there will not prevent an allocation of investment assets to the PE under the capital allocation approach. In addition, the fact that the enterprise may have assets trustee in another location which are considered for regulatory purposes to back the risk considered to have been assumed by the PE for tax purposes should not prevent an allocation

of an appropriate amount of such assets to the PE under the capital allocation approach (*i.e.* since those assets are factually available to back the risk assumed by the PE).

140. A question may theoretically arise in the case where, notwithstanding a convergence between the tax and regulatory conclusions as to where risk has been assumed, the amount of investment assets of the enterprise that are trusted in jurisdictions other than the PE jurisdiction would not leave a sufficient amount of “uncommitted” investment assets of the enterprise to satisfy an adequate allocation of investment assets to the PE under the capital allocation approach if the trusted assets were considered unavailable to the PE. Whilst such a case is considered highly unlikely to arise in practice, it would justify an appropriate adjustment to the application of the capital allocation approach (*i.e.* reducing the allocation of investment assets to the PE to take into account the insufficiency of uncommitted assets in the enterprise). On the other hand, where such an adjustment would leave the PE with a lower amount of investment assets than would be held by an independent insurance enterprise carrying on the same or similar activities and assuming the same or similar risks under the same or similar conditions, that would indicate that the capital allocation approach did not produce an arm’s length result in the particular case and therefore should not be used.

141. Another question that could theoretically arise is where, notwithstanding a convergence between the tax and regulatory conclusions as to where risk has been assumed, the investment assets required to be held in trusted accounts in the PE jurisdiction (representing both reserves and minimum surplus) exceed the amount of investment assets that would be attributed to the PE under the capital allocation approach. In many cases this will not be a problem in practice, as the amount of reserves and minimum surplus held as trusted assets may be less than the amount of investment assets that would have been allocated to that jurisdiction if the entire investment assets of the insurance company were taken into account. Accordingly, it might still be necessary to attribute more investment assets to the permanent establishment than is represented by the trusted assets. In this respect, the amount of the reserves and minimum surplus held as trusted assets is treated similarly to minimum regulatory capital in the banking context. Where, however, the reserves and minimum surplus held as trusted assets in the PE jurisdiction exceed the investment assets that would be attributed to the PE under the capital allocation approach and there is no conflict between the tax and regulatory attribution of risk to the PE, an appropriate arm’s length result would 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.

142. Life insurers may maintain separate account assets that are identified with specific clients and are generally more like investment holdings for which the insurer acts as investment manager for the clients. When determining the total investment assets to be allocated within the multinational enterprise the separate account assets should be taken into consideration to the extent that they are available to the insurer to pay claims or support risk.

143. As discussed in Part II (paragraph 95), allocating capital under the “standardised” approaches of risk-weighting assets under the Basel Accord is felt to be a reasonable approximation of an arm’s length result based on the relative risk-weighted assets properly attributed to each part of the banking enterprise. In the insurance industry, the absence of an internationally accepted regulatory standard makes it much more difficult to come up with a method for allocating total investment assets that both is a reasonable approximation of an arm’s length result and retains the main advantage of the standardised regulatory based approach, *i.e.* that the investment assets allocated to each part of the enterprise when added up should be neither more nor less than the actual investment assets of the enterprise. The rest of this sub-section examines a number of possible allocation keys that could be used to allocate the surplus to a PE in a manner that approximates an arm’s length result for an enterprise conducting insurance business.

1. Reserves for insurance risk

144. A potential key for allocating total investment assets could be to use the relative level of reserves for insurance risk in each part of the enterprise. However, this raises a number of problems. Countries differ quite a lot in their regulatory requirements for such reserves and some countries are more stringent in their requirements for such reserves than other countries (*e.g.* whether or not catastrophe or equalisation reserves are required), whilst other countries do not require such reserves at all. Further, there is a particular problem in using such reserves in the case of variable annuities (linked life assurance) which carry little risk to the insurer but require very high reserves for policyholder liabilities.

145. If reserves for insurance risk are to be used, questions also arise as whether home or host country regulations should be used. A further potential problem with using host country rules is that there may well be a trade-off in terms of a host country's regulatory policy for requiring reserves and surplus. For example, if stringent reserves for insurance risk are required then there is less need for surplus and vice versa. Consequently, investment assets would be over-allocated to countries under the host country approach where the regulatory regime focuses on reserves rather than on surplus.

146. Conceivably, insurance reserves (liabilities), as shown on the books and records of the home office, could be used as a key for apportioning the company's total investment assets to individual parts of the company and adjusting those investment assets, as needed, to take into account material distinctions (if any) between the type of insurance business conducted by the PE and the type of insurance business conducted by other parts of the company. An insurance company maintains books and records for regulatory and financial accounting purposes under uniform standards, showing the amount of reserves that are held to support its world-wide insurance business. In general, the amount of surplus that a company holds to support its insurance business is equal to its total investment assets less its insurance reserves. In Part II of this Report, one of the methods used to allocate capital to a PE in a banking business relies on the relative risk of the PE's assets, as compared to the assets held by the banking enterprise as a whole. Applying a somewhat analogous approach to an insurance enterprise in Part IV, total investment assets may be allocated to the reserves (liabilities) of an insurance PE by reference to the relative risk of the PE's reserves, as compared to other reserves held by the insurance enterprise. Of course, use of such an allocation key would be feasible only if the home country regulatory regime required the determination of reserves on a country-by-country basis by reference to the countries where the insurance enterprise assumes insurance risk, or where that regime uses a methodology for the determination of reserves that could be adapted to determine such a country-by-country breakdown.

147. Initially, a portion of the total investment assets of an insurance company is allocated to a particular PE, based that PE's relative share of the company's overall reserves. Adjustments are then made to this initial amount of investment assets allocated to the PE, by reference to the relative level of risk in the PE's business, as compared to the risks of the businesses carried on by other parts of the company. Of necessity, the nature and extent of adjustments in this regard will take into account the facts and circumstances, including for example assessments by the company concerning the relative riskiness of the insurance risk assumed by the PE. As distinguished from international banking, for example, which is governed by the Basel Accord, the insurance industry is not subject to internationally-agreed standards for evaluating the relative risk associated with reserves. Consequently, no uniform basis is available on which to allocate reserves (liabilities) and surplus (equity) to an insurance PE, as is the case for allocation of risks and subsequently capital to a banking PE. At the same time, many countries have developed or are developing methods for determining the relative risk associated with insurance reserves. Such methods might prove useful in allocating an appropriate amount of investment assets to an insurance PE.

148. Using the reserves as shown on the books and records of the home office as an allocation key (subject to the adjustments described herein), if feasible, may present certain practical advantages. These

reserves are computed under uniform rules and they are used for both business and regulatory purposes. Thus, they should provide a reasonable estimate of the economic liabilities that the company, its stockholders, creditors, and regulators view as arising from the insurance risk that the company has assumed from third parties. In some cases, the books and records maintained by the home office may in fact be the only accounting records available for evaluating the reserves and surplus of a PE, as for example if the host country relies on the home country to regulate insurance business conducted in the host country (e.g. among EU members). In such cases, the PE prepares no separate regulatory statements that might provide a starting point for evaluation of the amount of reserves and surplus held by the PE.

2. Premiums

149. Historically, a number of countries have used premiums as an allocation key when applying the formulary approach of Article 7(4) and therefore it should at least be considered whether it would be possible to use premiums as a key to the allocation of total investment assets in a manner consistent with the arm's length principle. Clearly, there are a number of situations where this would lead to an inappropriate result, especially where the premium key was applied to allocate total investment assets supporting different types of business where there was not a similar relationship between the level of premium and investment assets (and in particular, between the level of premium and assets representing surplus). For example, insurance for extremely unlikely but potentially catastrophic events like earthquakes might carry the same premium as motor insurance but would require vastly more in the way of surplus and hence investment assets. However, there may be scope for using premiums for lines of similar business where there is likely to be a direct relationship between the amount of premium and investment assets, for example, the sale of standardised insurance products marketed in only a few countries.

3. Other regulatory and hybrid approaches

150. There are other regulatory measures, such as solvency margins, minimum regulatory asset requirements, etc. which could potentially be used as keys to allocate the total investment assets. Moreover, any of the quasi thin capitalisation/regulatory minimum capital or thin capitalisation/adjusted regulatory minimum capital approaches described in the sub-sections below could also potentially be used not in their own right but as keys to allocate the actual investment assets (hybrid approaches). For example, the actual investment assets of the enterprise could be allocated according to the relative regulatory minimum surplus requirement in each part of the enterprise. These approaches are discussed in more detail in the sub-section below discussing quasi thin capitalisation approaches.

4. Provisional conclusion for capital allocation approach

151. More thought needs to be given to methods of allocating the total investment assets so as to approximate to an arm's length result. It is however clear that it is unlikely that a single allocation key could be found to allocate the total investment assets of a diversified insurance enterprise. It would therefore be interesting to know what data would be available to split the investment assets of an insurance business into the various business lines so that allocations could be made between locations within each business area using different allocation keys. It is hoped that the insurance industry will be able to assist greatly on this important matter.

152. Moreover, it should be borne in mind that the authorised OECD approach attributes risk and investment assets in accordance with the arm's length principle, rather than following regulatory approaches for measuring risks or determining assets. Regulatory developments will need to be carefully monitored to ensure that any changes do not affect the reliability of any regulatory approach as a proxy for measuring the risks attributable to an insurance PE under the arm's length principle.

c) Thin capitalisation / adjusted regulatory minimum approach

153. Another authorised OECD approach is the thin capitalisation approach. This would attribute investment assets to an insurance PE by reference to the amount of investment assets of an independent insurance enterprise carrying on the same or similar activities, using the same or similar assets and assuming the same or similar risks under the same or similar conditions. The strengths and weaknesses of this type of approach, which is broadly similar to the thin capitalisation approach discussed in Parts I and II, are discussed in those Parts (Section D-2(v) of Part I and Section D-1(iii) of Part II). Similar issues are likely to arise for insurance companies.

154. One proposal put forward by commentators is that the amount of reserves and surplus on the regulatory filings of the PE might be viewed as the appropriate amount of investment assets attributable to the PE under the authorised OECD approach. As discussed below in sub-section (d), the amount of the regulatory reserves and surplus of the PE generally is not necessarily a reliable metric under the authorised OECD approach, given that it may not reflect an arm's length amount of investment assets in relation to the risk-weighted liabilities. An acceptable variant of the thin capitalisation approach, however, would start with the amount of reserves and surplus indicated in the PE's regulatory filings and would then make adjustments to reflect economic reality. Clearly, the facts and circumstances of each case will dictate the nature and the reliability of the starting point of the adjustments needed to apply this approach in an acceptable manner. It should be noted that, under certain facts and circumstances, the PE's regulatory reserves and minimum surplus may in fact constitute an arm's length amount, without material adjustments, but the essence of the adjusted regulatory minimum approach, and what distinguishes it from the quasi thin capitalisation / regulatory minimum approach described below in sub-section (d), is that an analysis would have to be conducted to determine whether adjustments were necessary to achieve an arm's length result.

155. The nature and extent of adjustments that must be made to the regulatory reserves and surplus of the PE will vary. For example, the PE may use a substantially greater amount of investment assets in conducting its insurance business in the host jurisdiction than the reserves and minimum surplus amounts indicated in the PE's regulatory filings, which in some cases might mean that the PE has assumed more risks in the host country than it reported for regulatory purposes. Ideally, the books and records of the PE would allow identification of the nature of the business activities carried on by the PE and the level of assets that the PE requires to perform those activities. Adjustments may be needed, for example, to ensure that the amount of reserves and surplus attributed to the PE is comparable to the reserves and surplus held by insurance businesses that engage in similar activities and that accept similar levels of insured risks in the host country. Adjustments may also be needed to ensure that the amount of investment assets allocated to the PE is not excessive, in view of the total investment assets of the insurance company as a whole.

d) Safe harbour – Quasi thin capitalisation / regulatory minimum approach

156. Another possibility would be to require the PE to have an amount of investment assets at least equal to its reserves (as determined under the host country's regulatory regime) plus the same minimum amount of surplus required for regulatory purposes (regulatory minimum surplus) as would an independent enterprise conducting insurance business in the host country (*a quasi thin capitalisation approach*). The regulatory minimum surplus would be determined in accordance with the regulatory standards of the host country. Insurance regulatory standards generally determine the minimum amount of surplus that an insurance company must possess before it is given regulatory permission to carry on business in a particular jurisdiction. Therefore, it is useful to see what these standards require and how they define those requirements to see if they could be used to attribute surplus, either directly as part of a safe harbour quasi thin capitalisation approach or indirectly as an allocation key under the capital allocation approach

described above. Generally, the standards differ in the way the minimum surplus amount is calculated, but the amount required will bear a close relationship to the nature of the risks undertaken.

157. The extent to which differing types of risk assumed by the enterprise affect respectively the reserves and minimum surplus required varies from jurisdiction to jurisdiction. This may be because in some cases, particularly in life insurance, matters such as risks inherent in the assets used to back the business may be taken into account in determining the reserves for policyholder liabilities. The more such risks are taken into account in that area, the less they need to be taken into account in determining the surplus needed. For example, a regulator may require a company to calculate its reserves by assuming only a risk-free rate of return such as can be obtained on Government securities, even though the company holds equity investments likely to produce a greater return.

158. It should be possible to determine for any given PE what the minimum assets required for that PE by the host state regulator will be (although there are problems in the European Union due to the liberalisation of host country regulation). The regulators will generally be concerned with “admitted assets”, or those assets that are sufficiently liquid so that they can be used to pay claims. Either the regulator will actually require the PE to demonstrate that the amount of admitted assets is available in the jurisdiction, for example, by being retained in a trust, or the regulator’s criteria can be applied to the PE. However, this may not be the arm’s length amount of investment assets that should be attributed to the PE. Moreover, this approach does not provide information about which of the assets that satisfy the minimum requirements are subject to taxation, which income and gains will be taxed or what rate of return should be obtained on those assets (see sub-section (f) below).

159. Accounts of the PE may also show more assets than the reserves and bare minimum surplus requirement of the host state regulator. Indeed, if the PE holds assets in excess of the reserves and minimum surplus required it would be expected that any accounts would show this as well as the income and gains arising from them and such assets may also be attributed to the PE under the authorised OECD approach. But the PE’s accounts may not be drawn up on a basis that reflects the distinct and separate enterprise approach. It is necessary to start from the authorised OECD approach to establish what assets and what income and gains flowing from them should be attributed to the PE. Similar to the situation described for banks, an arm’s length attribution of reserves and surplus (and hence assets) may have to be made to an insurance PE, even though no such reserves or surplus (or assets) have been formally attributed to the PE for regulatory or other purposes.

160. The focus of the “quasi thin capitalisation/regulatory minimum capital” approach is on providing an administratively simple way of ensuring that the PE cannot have less assets than its regulatory reserves and the regulatory minimum surplus for an independent enterprise conducting insurance business in the same jurisdiction. This approach is not an authorised approach for the attribution of investment assets as it ignores important internal conditions of the authorised OECD approach, *e.g.* that the PE generally has the same creditworthiness as the enterprise as a whole. However, as in the case of the comparable capital attribution method described in Parts I-III, it may be acceptable as a domestic law safe harbour in the host country which is also allowable under the authorised OECD approach as long as it does not result in the attribution of more profits to the PE than would be attributed by an authorised approach. In many cases the effect of using a quasi thin capitalisation/regulatory minimum capital approach as a domestic law safe harbour would be that the host country taxes less than it would using a capital allocation or thin capitalisation/adjusted regulatory minimum approach.

e) Conclusion on attributing investment assets to the PE

161. The attribution of investment assets representing both reserves and surplus among parts of an enterprise involved in insurance business is a pivotal step in the process of attributing profit to its PE. In particular, it largely determines the amount of investment income that the PE should be considered to have. For insurance enterprises, surplus fulfils a similar role as capital for other enterprises. So an insurance PE, just like any other type of PE, should have sufficient surplus, in addition to its reserves, to support the functions it undertakes, the assets it uses and, crucially, the insurance and other risks it assumes. For this reason, the method by which investment assets are attributed is an important step in avoiding or minimising double taxation.

162. The consultation process on Parts I-III has shown that there is an international consensus amongst governments and business on the principle that a PE should have sufficient capital to support the functions it undertakes, the assets it uses and the risks it assumes. However, it is not possible to develop a single internationally accepted approach for making that attribution of capital, including “free” capital. As can be seen from the discussions above, there is no single approach which is capable of dealing with all the circumstances of an insurance business and so the same conclusion is reached for the attribution of investment assets to an insurance PE.

163. Rather, the focus of the OECD work in this Part IV is on articulating the principles under which such an attribution of investment assets should be made and on providing guidance on applying those principles in practice and in a flexible and pragmatic manner. As such, whilst any of the authorised approaches described in this section are capable of producing an arm’s length result, there may be particular situations where the approach does not produce an arm’s length result and so flexibility may be required but in a manner that minimises the incidence of double taxation.

164. Nevertheless, there will inevitably be some cases where tax administrations disagree over whether the results produced by the host country method are consistent with the arm’s length principle. The Mutual Agreement Procedure is available to resolve such differences. The fact that it will sometimes be necessary to resolve disputes through MAP is not a weakness of the authorised OECD approach. Rather it reflects the fact that the attribution of investment assets to an insurance PE can be a very difficult and complex issue. The authorised OECD approach describes the strengths and weakness of different approaches and therefore provides a framework for resolving difficult cases.

f) Determining the investment yield from investment assets attributed to a PE

165. The determination of the amount of investment assets to be attributed to the PE is not the end of the matter. The next question is what investment yield should be attributed to the assets. The answer will depend on the extent to which the method chosen to determine the amount of the investment assets makes it possible to directly identify all the assets supporting the insurance risk. To the extent that is not possible (*e.g.* under either the capital allocation or the thin capitalisation/adjusted regulatory minimum approach) some means of identification would have to be developed.

166. In general, the return earned on the investment assets (reserves and surplus) that are properly attributable to the PE should correspond closely to the return earned on investment assets actually held in the host country (*i.e.* including trustee assets) to support the insurance contracts issued by the PE. In the case of a PE jurisdiction that has required the non-resident enterprise to place particular assets in trust, it would be appropriate to attribute the investment income earned with respect to those assets to the PE to the extent that key entrepreneurial risk-taking function is performed by a PE in that location. However, it would still be necessary to determine an investment yield with respect to investment of any assets that are

attributed to that jurisdiction above and beyond what is represented by the assets actually held by the PE and recorded on its books.

(1) *Top-down approach to determining investment yield on additional assets*

167. To the extent that the amount of investment assets attributable to the PE exceeds the amount of investment assets actually held in the host country, the PE ideally should be attributed an investment return equal to the return earned on all investment assets held by the company that are not required to be held in trustee accounts in other countries to support business, which may be referred to as “uncommitted” investment assets (*i.e.* a so-called “top-down” approach to determining investment yield on that additional amount of investment assets). It is acknowledged, however, that determining the appropriate investment return to apply to an insurance company’s “uncommitted” investment assets under the authorised OECD approach may present particular challenges. 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. Either way, adjustments may be needed to prevent distortion in investment returns on account of investments in underperforming or non-performing assets or in assets denominated in currencies subject to high rates of inflation.

168. A variation on the top-down approach could try to identify the yield on those categories of the insurance company’s uncommitted investment assets that are most appropriate to associate with the PE, in light of the nature of the insurance risk assumed by the PE. The determination of the types of assets to be attributed to the PE will depend upon the facts and circumstances of each company, but in addition to the accounts of the PE, there are a number of factors that may provide guidance in this regard. Different types of insurance business call for different types of assets. Some types of life insurance business for example may be backed heavily by equities, while, where annuities are in payment, insurance companies may seek to support these obligations with Government and other less risky debt securities that have an investment return profile that matches the expected annuity payment profile.

169. Another factor in determining the yield on those categories of the insurance company’s uncommitted investment assets that are most appropriate to associate with the PE may be the currency in which assets are denominated. Insurance regulations generally insist on more or less complete matching of the currency of assets and liabilities, to prevent excessive foreign exchange exposure. Accordingly, the identification of assets whose yield is appropriate to take into account in determining the PE’s yield on must consider the denomination of assets, including any related hedging of currency risks, to ensure both that the appropriate assets are attributed to the PE and that an arm’s length rate of return is determined for those assets.

(2) *Bottom-up approach to determining investment yield on additional assets*

170. Another more direct method would be to assume that the rate of return earned on investment assets held in the host country of the insurance PE is also earned by the “uncommitted” investment assets notionally attributed to the PE to satisfy its investment asset attribution requirement above and beyond the investment assets actually held by the PE. The results under either this approach or the “top-down” approach necessarily constitute proxies for the actual return on free investment assets.

iv) *Recognition of Dealings*

171. As noted in paragraph 210 of Part I, because a PE is not legally or economically separate from the rest of the enterprise of which it is a part, and because dealings between a PE and the rest of the

enterprise have no legal consequences for the enterprise as a whole, there is a need for greater scrutiny of such dealings than of transactions between two associated enterprises. This also implies a greater scrutiny of documentation (in the inevitable absence, for example, of legally binding contracts) that might otherwise exist, and considering the uniqueness of this issue, countries would wish to require taxpayers to demonstrate clearly that it would be appropriate to recognise the dealings. In short, it will be necessary first to determine whether any dealing exists in relation to the PE before deciding whether the dealing, as found, should be used as the basis for the analysis used to determine an arm's length attribution of profit.

172. It was seen in Parts II and III of this Report that problems may arise when trying to apply the guidance in Part I to dealings in relation to financial assets and risks, given the nature of financial businesses. Similar problems arise in relation to insurance. An insurance business consists of assuming risk of losses arising from the realisation (or timing) of events outside the control of the insured. Insurance businesses are able to assume insurance risk by pooling the insured risks of many risk-averse persons via the payment of an amount by the insured to the insurer, called a premium. To be able to accept the insured risk, and assume the associated insurance risk, the insurer holds investment assets, which give rise to investment income.

173. Once the threshold has been passed and a dealing is recognised as existing, the authorised OECD approach applies, by analogy, the guidance at paragraphs 1.26-1.29 and 1.36–1.41 of the Guidelines. The guidance is applied not to transactions but to the dealings between the PE and other parts of the enterprise. So the examination of a dealing should be based on the *dealing* actually undertaken by the *PE and the other part of the enterprise* as it has been structured by them, using the methods applied by the taxpayer insofar as these are consistent with the methods described in Chapters II and III of the Guidelines. Except in the two circumstances outlined at paragraph 1.37 of the Guidelines, tax administrations should apply the guidance in paragraph 1.36 when attributing profit to a PE and so “should not disregard the actual *dealings* or substitute other *dealings* for them”.

v) *Internal Reinsurance*

174. The potential “dealing” that appears most problematic initially is “reinsurance” within a single legal entity. However, the guidance developed under Part I provides a reasonable answer.

175. Insurance companies commonly buy reinsurance from both unrelated and related reinsurance companies. Through reinsurance, insurers can manage their underwriting and investment risk. By buying reinsurance, insurers can “free up” surplus (reduce the amount of surplus needed to support reinsured business) and reduce reserves, which allows insurers to write more insurance contracts.

176. Under the authorised OECD approach, 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 key entrepreneurial risk-taking function.

177. 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.

C-2. Second Step: Determining the Profits of the Hypothetical Distinct and Separate Enterprise (Based on a Comparability Analysis)

178. As noted in Section C-1 of this report, the functional and factual analysis of the first step of the authorised OECD will have appropriately hypothesised the PE and the rest of the insurance enterprise as associated enterprises, each undertaking functions, using assets and assuming risks. Under the first step, investment assets, such as those arising from the investment of reserves and surplus, will also have been attributed in an appropriate amount to the part of the enterprise which performs the key entrepreneurial risk-taking function of assuming insurance risk. Moreover, in fully hypothesising the PE as a distinct and separate enterprise, it will have been necessary to identify and determine the nature of its internal “dealings” with the rest of the enterprise of which it is a part.

179. The second step of the authorised OECD approach goes on to apply, by analogy, the guidance in the Guidelines to any economic relationships (dealings) between the hypothesised distinct and separate enterprises, *i.e.* the PE and the rest of the insurance enterprise. For example, although insurance risk and the assets backing that risk may have been attributed to the PE in Country A by virtue of the fact that the PE undertook the key entrepreneurial risk-taking function of assuming that risk, it may be that other parts of the enterprise performed other functions, such as investment management services in relation to those assets, or provided valuable intangibles, etc. These functions or intangibles would need to be rewarded in order to ensure that the PE in Country A is attributed an arm’s length profit, using any of the methods authorised by the Guidelines. The authorised OECD approach would be to record all the income associated with the insured risks accepted by the PE and the supporting investment assets in the books of the PE in Country A as the “economic owner” of the portfolio of risks and supporting assets and to attribute to it expenses in respect of the dealings representing an arm’s length reward for the functions performed by other parts of the enterprise. In particular, the concept of comparability analysis will be used in order to attribute profit in respect of these dealings by making a comparison with transactions undertaken between independent enterprises. It should also be noted that there is no presumption that these other dealings are by nature of low value. This will be determined by the functional and comparability analyses based on the particular facts and circumstances. A whole spectrum of results can be expected ranging from at one end routine low value dealings to at the other end dealings that result in a share of the residual profit of the economic owner.

180. General guidance on making such comparisons has been provided in Section D-3(iii) of Part I of this Report. This section discusses how to apply that guidance to issues specific to a PE conducting an insurance business.

i) Applying Transfer Pricing Methods to Attribute Profit

181. Having established that a dealing has taken place and that the dealing as structured by the taxpayer would not need to be disregarded or re-characterised, the next issue is to determine whether the profit attributed to that dealing by the insurance enterprise is at arm’s length. This is done by applying the guidance in the Guidelines on comparability, by analogy, in the insurance PE context. A comparison is made of the reward earned from *dealings* within the insurance enterprise with comparable *transactions* between independent enterprises, having regard to the 5 factors for determining comparability set out in Chapter I of the Guidelines.

182. Further, the authorised OECD approach provides that all methods in the Guidelines can be applied in the PE context in order to determine the profit to be attributed in respect of the dealing by reference to comparable uncontrolled transactions. In the first instance, the traditional transaction methods should be examined to see if comparables from uncontrolled transactions are available. In this context, the

guidance at paragraphs 2.7, 2.14 and 2.34 of the Guidelines should be borne in mind where differences are found between the dealing and the uncontrolled transaction under respectively the CUP, resale price and cost plus methods. As noted at paragraph 2.7, “The uncontrolled transaction may be comparable, if one of two conditions is met: (1) none of the differences (if any) between the transactions (*in the PE context between the uncontrolled transaction and the dealing*) being compared or between the enterprises undertaking those transactions could materially affect the price in the open market; or (2) reasonably accurate adjustments can be made to eliminate the material effects of such differences.”

183. Whilst it is difficult to identify a service sharing the characteristics of writing insurance business, an insurance enterprise itself nonetheless utilises many services for which comparables can be found and makes use of its financial assets, in terms of investing them, in ways similar to other types of enterprises. The guidance at paragraph 1.19 of the Guidelines should therefore be applicable to services provided to insurance enterprises in most respects.

184. The second comparability factor, functional analysis, may be more problematic. An insurance business involves numerous functions, not necessarily carried out in sequential order. The trend for increasing mergers and acquisitions reduces the number of potential comparables. Moreover, the dealings related to these functions may be structured in a different way from the way transactions between independents are structured. For example, the performance of related functions may be split between different parts of the enterprise whilst such functions would be performed together by independents. This makes it difficult to evaluate such integrated dealings in isolation and to apply reliably any of the traditional transaction methods. Such problems also occur with increasing frequency in transactions between associated enterprises and Chapter III of the Guidelines approves other methods (transactional profit methods) to be applied in situations where the traditional transaction methods of Chapter II cannot be applied reliably. More positively, the trend to outsourcing various parts of the value chain of an insurance business may create additional potential comparables at least for functions that have been outsourced.

185. With regard to the third comparability factor, contractual terms, no particular conceptual difficulties are envisaged in the insurance area, although there may be practical difficulties due to the lack of contemporaneous documentation or other evidence of the intention of the parties, etc. The general guidance in Part I of this Report should be followed in order to determine the division of responsibilities, risks and benefits between the parties to the dealing.

186. In some countries, internal dealings are often not well documented and this gives rise to the issue of how to determine the terms of any dealing. However, associated enterprises also do not always document transactions and this issue is covered by paragraph 1.28 of the Guidelines. That guidance can be applied, by analogy, by equating “terms of the dealing” with “contractual relationships”. Consequently, “where no written terms exist, the *terms of the relationship* of the parties must be deduced from their conduct and the economic principles that generally govern relationships between independent enterprises.”

187. The fourth comparability factor, economic circumstances, is of particular importance when attributing profits to an insurance PE. Following the guidance of paragraph 1.30 of the Guidelines, different insurance regulatory regimes should be considered as potentially affecting market comparability. For example, it would not be correct to treat market data from a less regulated market as comparable to dealings in a more regulated market without making reasonably accurate adjustments for those regulatory differences.

188. It is not considered that there are any particular conceptual difficulties in applying the general guidance on the final comparability factor, business strategies, to attribute profit to an insurance PE. The issue is of importance because the strategic management of the insurance enterprise determines the nature,

size and even geographical location of the risks underwritten. However, any relevant business strategies should be taken into account and should have been determined by the functional analysis under the first step of the authorised OECD approach.

189. The discussion above is based on the comparison of individual dealings with individual uncontrolled transactions. In practice, an insurance business usually consists of a large number of similar financial assets, risks and dealings. Accordingly, it may be particularly appropriate to apply the guidance on aggregating transactions at paragraph 1.42 of the Guidelines in the insurance context. For example, a comparability analysis could be made between suitably aggregated dealings and suitably aggregated uncontrolled transactions such as a portfolio of closely linked and similar investment assets.

ii) *Rewarding Specific Insurance Functions*

190. Having discussed in general terms in the previous sub-section how to apply the second step of the authorised OECD approach to attribute profits to an insurance PE, this sub-section looks at some specific yet commonly occurring situations in more detail.

a) Underwriting insured risk

191. 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. As noted in Section B-2 there are a large number of other functions necessary to undertake insurance business. If these are performed by other parts of the insurance enterprise, then there are dealings that have to be taken into account in order to reward the performance of those functions. The rest of this section looks at those dealings in more detail.

192. 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. For example, simply issuing the contract or “rubber stamping” a decision made elsewhere does not warrant being treated as performing the underwriting/risk acceptance function. The essence of underwriting is the decision to accept insured risk and this will depend very much on the type of insurance business. For very standardised products, for example travel insurance sold through vending machines at airports, the underwriting/risk acceptance function is not undertaken by the vending machine but by the person who developed the product and set the insurance limits.

b) Risk management and reinsurance

193. In the overwhelming majority of cases, the risk management function of deciding whether to reinsure externally or retain risks assumed by the PE will not give rise to an internal reinsurance dealing. However, the decision to reinsure may be informed by advice and analysis provided by specialists (*e.g.* actuaries) located elsewhere within the insurance enterprise than the “reinsuring PE”. The cost of such services should be considered a legitimate expense of external reinsurance acquired by the PE and an arm’s length compensation should be imputed to the services dealing for tax purposes.

194. Risk management and other related functions such as asset/liability management can be an important factor in determining the profitability of insurance enterprises and so would be rewarded accordingly. An issue arises as to the form that reward should take and in particular whether such functions should be rewarded by profit methods. A full comparability analysis should help show whether a profit method is in conformity with the arm's length principle. Profit methods may have to be used where it is not possible to apply reliably traditional transaction methods to attribute profits to the part of the enterprise performing the risk management functions. This may occur where independent enterprises performing similar risk management functions would demand a share of the profit or where the risk management function is so integrated with the other functions that it is not possible to make an evaluation in isolation. This can be either a share of the gross or the net profits.

195. Issues also arise as to how to determine where operational risk is being managed. The risk that a liability may arise through the operation of a business resides with the part of the enterprise responsible for managing the activity giving rise to the operational risk. In the case of operational risk arising from the illegal activity of an employee, if a PE was responsible for managing the rogue employee then that PE is treated as assuming the operational risk. Any profit from performing functions related to the undertaking of that risk is properly allocated to the PE. To the extent that the head office performs functions that lead to the assumption of the operational risks that otherwise would be related to the activities of a PE, the head office should be compensated for assuming these risks. It may be possible to find comparables for such dealings as it is becoming common for enterprises to purchase insurance against operational risk from third parties.

c) Asset management

196. Asset management should produce few conceptual difficulties in relation to insurance enterprises. Such enterprises are generally considerably more conservative in their investment activity than, say, banks and may, under their asset/liability matching requirements invest in long term investments rather than seeking trading profits by being continually active in the market. As such it should be possible to find suitable comparables for investment management functions from those organisations, *e.g.* fund managers, that provide asset management services, though the particular requirements of the insurance business may necessitate adjustment to the comparables in order to make them reliable.

197. It should be borne in mind that following the authorised OECD approach (and as described in Section C-1(iii) of this part of the Report), assets are attributed to PEs in an appropriate proportion to the level of insurance risk which the PE has assumed. The risk assumed will therefore reside in the PE so that "ownership" of the supporting assets, the associated investment income, the asset/liability mismatch risk and the market risk (or investment yield risk) also resides in the PE. That part of the enterprise which manages the assets should therefore be rewarded appropriately for the investment management function by the part of the enterprise that is treated as the "economic owner" of the assets. This reward would be determined in accordance with the Guidelines.

198. It may be the case that the head office is explicitly "managing" the investment of assets for its PEs, on the basis that it is able to do so more effectively than the PE, through economies of scale, expertise, etc. Such an arrangement raises issues of compensation for the investment management function under the second step of the authorised OECD approach.

d) Product management / product development

199. It will be part of the functional and factual analysis to determine which part of an enterprise designs and develops particular new products, the customer base at which the product is directed and the

probability of a particular PE wishing to benefit and/or benefiting from the new product. In other words, the salient facts in the functional and factual analysis will be which parts of the enterprise have helped develop the product, whether it is a generalised product marketed by all parts of the enterprise (and perhaps capable of being marketed by third parties) or whether it is a specialised product with a customer range limited to only specific PEs.

200. Compensation should be attributed to those parts of the enterprise engaged in development of the product. Generally, following the authorised OECD approach, the compensation should be on arm's length terms and should be provided by those parts of the enterprise which benefit from the product's sale. However, determination of the level of benefit enjoyed by a particular PE (and whether it ought to be treated as compensating the product developer for that benefit) is a question which will turn on the facts of the particular case. The guidance in Chapters VI and VII of the Guidelines (or Chapter VIII in the circumstances where the product is developed by something analogous to a CCA) should be followed, by analogy, in such cases.

201. Once it is decided that an arm's length price should attach to the dealing then, depending on the level of sophistication of the product and the degree to which it has proprietary features, a market comparable may be found using the CUP method. Otherwise it may be necessary to arrive at an arm's length price using other methods authorised by the Guidelines.

e) Sales and marketing

202. Traditionally, most insurance products have been sold directly (*i.e.* "one-to-one") by an agent or broker. Where one part of an enterprise markets the insurance product directly to third parties and then proceeds to contractually commit to and underwrite that business, the authorised OECD approach will attribute to that PE the underwriting risk arising from the sale together with an appropriate level of assets to support the risk assumed (including investment income associated with those assets).

203. However, with continuing development of telecommunications, it is becoming more common for one part of the enterprise to advertise or "market" products on behalf of the whole enterprise or other specific parts of it. The customer may be directed to approach a part of the enterprise other than the marketer in order to contractually commit to purchase of the product and, if the business is underwritten by the other part of the entity, the "sale" will generally be booked there (although the same effect could be achieved if the premium payments are received by the "marketer" and passed on to the "underwriter" less a commission to reward the marketing function). Subsequent premium payments may similarly be made to parts of the enterprise other than the "marketer".

204. If the enterprise as a whole is marketing a product on behalf of an independent entity (third party or an affiliate), the reward which the enterprise receives should be at arm's length (either directly if from a third party or, if it is an affiliated transaction, following application of the Guidelines). That reward should be allocated amongst those parts of the enterprise involved in the marketing and it should be possible to arrive at the arm's length compensation due to each part of the enterprise using the Guidelines and by making reference to comparable services available from unrelated providers.

205. Where one part of the insurance enterprise markets a product on behalf of another part of the same enterprise, or of the enterprise as a whole, the issues are more complex. In these circumstances it is very important that the facts are fully established by the functional and factual analysis. For example, one part of the enterprise may advertise a product from one jurisdiction (*e.g.* over the phone or internet) but instruct customers to conclude the contract with and pay premiums to a PE in another – possibly a third – jurisdiction. In these circumstances, under the authorised OECD approach the risk incurred in concluding

the contract and underwriting the business will reside with the PE that performed the underwriting/risk acceptance functions. Assets to support that risk will accordingly be attributed to that PE. The cost of marketing the product sold will be an allowable expense for tax purposes and an arm's length compensation to the marketer may be imputed.

206. An issue arises as to whether for some of the more complex insurance products, there is a role equivalent to the "structuring" role in global trading as described in Part III of this Report. (See paragraphs 93-94 above.)

f) Support functions

1) *Credit analysis*

207. The provision of credit analysis should be rewarded on arm's length terms. This function should not give rise to any conceptual difficulties and suitable arm's length comparables for the services provided should be fairly readily available.

2) *Treasury*

208. In the insurance industry, the treasury function is normally not seen as a profit centre. One would therefore expect the treasury people to be primarily involved in raising finance and making it available to the profit centres. This raises the issue of whether treasury dealings with PEs should attract arm's length prices. The discussion at paragraphs 194-196 of Part I of this Report will be helpful in this regard.

3) *Regulatory compliance*

209. Regulatory compliance may be a requirement of the enterprise as a whole, of the PE itself (in respect of host country regulations) or both (*i.e.* the PE will be subject to both home and host country regulation). Where the PE is subject – because the enterprise as a whole is subject – to home country regulation, it is most likely that the head office will undertake the regulatory compliance function. Under the authorised OECD approach it may be considered appropriate to allocate an arm's length fee to the head office for providing the service. However, if the PE were a distinct and separate enterprise, it is not always clear that it would be subject to "home" country regulation and thus would not require assistance in ensuring regulatory compliance. One approach to this issue would be that compliance with home country regulation is one of the "same or similar conditions" required by Article 7(2). In other words, in determining the arm's length remuneration to be allocated by the PE to the head office for the provision of this service, the PE would be analogised to a distinct and separate enterprise that was subject to regulation in the head office country.

210. Where the PE has to satisfy the requirements of the host country, then an arm's length compensation will be due to whichever part of the enterprise undertakes the compliance work on behalf of the PE with a corresponding allowable deduction in computing the profits of the PE.

4) *Systems and development of intangibles*

211. Although the role of information technology is significant (and becoming increasingly so) in the insurance industry, development of IT systems within the industry does not give rise to any conceptual

difficulties not met elsewhere. Similarly, intangibles such as trade names are of very great value in the industry, but do not present any transfer pricing challenges not previously addressed. The detailed discussions in Section D-3(iv)(b) of Part I of this Report should be helpful in determining a suitable solution for enterprises using intangibles in conducting their insurance business.

5) *Other back office functions*

212. The back office support structure is of importance in the insurance industry, though perhaps less so than in banking. The various back office support functions need to be considered when attributing profit to the various parts of the enterprise.

213. As noted at paragraph 189 of Part II of this Report “One area where there is a difference between the authorised OECD approach and the existing Article 7 position is that under the authorised OECD approach, the arm’s length principle is applied to determine the reward for performing that service. Previously, it was possible only to allocate costs. Application of that principle will take account not only of the price applied to the service but also following the guidance in Chapter VII, whether, at arm’s length, both parties would have contracted for the provision of the service.....[T]he tests at paragraph 7.6 of the Guidelines will prove helpful in resolving such issues. Moreover, application of the arm’s length principle may indicate a price for the service rendered that is above or below the costs incurred by [other parts of the enterprise] in providing it (see paragraph 7.33 of the Guidelines).”

214. In practice, as noted at paragraph 190 of Part II of this Report, “Where the head office or other part of a bank provides centralised services to a PE that are similar to those provided by an associated centralised service provider in an MNE group, similar techniques may be used as apply to associated enterprises. However, services provided by a head office or other part of an integrated enterprise may be different from those provided by the parent or centralised service provider of an MNE group. Accordingly, whilst similar techniques can be used as for associated enterprises, CUPs are more likely to be unavailable, so that cost plus methods are likely to be particularly relevant.”

215. If the enterprise has a CCA-type arrangement in respect of back office services, the guidance in Chapter VIII of the Guidelines on applying the arm’s length principle to services that are subject to CCA activity should be followed.⁶

6) *Claims administration*

216. This is an important, though at times under-recognised, function in the insurance industry. Efficient loss adjustment and effective pursuit of claims against reinsurers can affect very significantly profits earned. Clearly, if the PE performs this function itself and only in respect of business it has underwritten, no problems arise. However, the PE may perform the function on behalf of other parts of the enterprise or the head office or another PE may act for it. Where the functional service is provided in those circumstances, the service provider is entitled to an arm’s length compensation. Some fee or commission basis suggests itself as a suitable methodology for attributing the reward. Arm’s length comparables may well be available and may provide an alternative basis for compensation of the service provider. If that is the case, the functional and factual analysis should provide a means for testing the suitability of the comparable against the specific circumstances of the PE.

⁶ See paragraph 191 of Part II, which discusses the possibility of a “CCA” within a single legal enterprise.

D. Article 7(4) – Is it Unnecessary?

217. Article 7(4) provides that insofar as it has been customary to determine the profits attributed to a PE on the basis of an apportionment of total profits of the enterprise, nothing in Article 7(2) shall preclude continued use of that method, provided that the result shall be in accordance with the principles contained in Article 7, *i.e.* including the arm's length principle of Article 7(2). The Commentary reiterates that the approach is acceptable only if "the result can fairly be said to be in accordance with the principles contained in the Article" and stresses that the method "is generally not as appropriate as a method which has regard only to the activities of the PE".

218. In Section F of Part I of this Report, the question was posed whether adoption of the authorised OECD approach would render Article 7(4) redundant. The conclusion as reflected in paragraph 296 is that, "Accordingly, there was a broad consensus among the member countries that under the authorised OECD approach only paragraphs 1, 2 and 3 of Article 7 are needed to determine the attribution of profits to a PE. A possible exception to the above conclusion relates to the attribution of profit to a PE of an enterprise carrying on an insurance business. The member countries have not yet finalised Part IV of the Report on the insurance industry but the view of most countries is that (given that under the authorised OECD approach only paragraphs 1, 2 and 3 of Article 7 are needed to determine the attribution of profits to a PE) there is no continuing need for Article 7(4)."

219. Section C-1(iii) of this Part of the Report has now described how a level of assets and associated income should be attributed to an insurance PE, that level being appropriate to support the level of risk assumed by the PE. By hypothesising an appropriate level of assets (based on risks actually assumed by the PE) to the PE and then, following a full functional and factual analysis, attributing an arm's length price to dealings actually entered into between the PE and the rest of the enterprise of which it is part, it is considered possible to arrive at a close approximation to the profits which the PE would have made as a truly distinct and separate enterprise. The authorised OECD approach therefore appears to be in close accordance with the principles embodied in Article 7.

220. In the past, the use of apportionment methods authorised by Article 7(4) has been necessary because of the difficulty in arriving at an arm's length attribution of profits to an insurance PE. However, as this Part of this Report demonstrates, application of the authorised OECD approach appears to be capable of producing a result more in accordance with the principles of Article 7 than those methods. Accordingly, it is difficult to imagine circumstances in which such methods would be preferable to application of the authorised OECD approach. This leads most of the member countries to the conclusion that Article 7(4) is redundant, even for enterprises conducting insurance business.

E. Article 7(7) – Coordination with Article 10(4), etc.

221. Article 7(7) of the OECD Model Tax Convention provides that: "Where profits include items of income which are dealt with separately in other Articles of this Convention, then the provisions of those Articles shall not be affected by the provisions of this Article."

222. Insurance companies, by the nature of their business, frequently invest in assets in connection with their business that give rise to income falling within other Articles – in particular the dividend and interest Articles. So the question arises whether the authorised OECD approach has any application to those items of income where Article 7(7) applies.

223. The clear answer is "Yes". In each of the other Articles referred to, there is a provision under which those parts of the Article which limit the taxing rights of the state where the income arises are

disapplied where the income or gains is attributable to a PE in that State. And the Commentary on Article 7(7) reinforces this:

33.....If the profits of an enterprise include categories of income which are treated separately in other Articles of the Convention, e.g. dividends, it may be asked whether the taxation of those profits is governed by the special Article on dividends etc., or by the provisions of this Article.

34. To the extent that an application of this Article and the special Article concerned would result in the same tax treatment, there is little practical significance to this question. Further, it should be noted that some of the special Articles contain specific provisions giving priority to a specific Article (cf. paragraph 4 of Article 6, paragraph 4 of Articles 10 and 11, paragraph 3 of Article 12, and paragraph 2 of Article 21).

35. It has seemed desirable, however, to lay down a rule of interpretation in order to clarify the field of application of this Article in relation to the other Articles dealing with a specific category of income. In conformity with the practice generally adhered to in existing bilateral conventions, paragraph 7 gives first preference to the special Articles on dividends, interest etc. It follows from the rule that this Article will be applicable to industrial and commercial income which does not belong to categories of income covered by the special Articles, and, in addition, to dividends, interest etc. which under paragraph 4 of Articles 10 and 11, paragraph 3 of Article 12 and paragraph 2 of Article 21, fall within this Article.....

224. Since provisions such as Article 10(4) provide that, in the case there dealt with, Article 7 applies if the holding in respect of which the dividend is paid is effectively connected with the PE, then Article 7 will apply to dividends (and interest) derived from the State where the PE is established if they are attributed to the PE.

225. From the Commentary to Articles 10 and 11 it is clear that for a holding to be effectively connected with a PE it does not have to be held at the PE. The authorised OECD approach provides significant guidance on the amount and categories of investment assets held by an insurance enterprise the income or gains on which are to be taken into account in determining the profits attributable to the PE on the assumptions laid down in Article 7. Thus, it would be surprising if the provisions of Article 10(4) or 11(4) permitted a different answer to be given than if Article 7(7) did not exist. This was clearly not the intention behind these Articles. It is suggested that the Commentary on these Articles might be made explicit on this point and say that where income or gains are attributable to a PE by virtue of Article 7 then they will automatically be regarded as effectively connected within the meaning of Article 10(4), etc.