Position Paper

Insurance Europe comments on the OECD discussion draft on BEPS action 2: "Neutralise the effects of hybrid mismatch arrangements"

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Contact person:	Daniel Madejski, Policy Advisor, Taxation	E-mail:	madejski@insuranceeurope.eu
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Introduction

Insurance Europe welcomes the opportunity to comment on the OECD BEPS action plan 2 discussion draft *"Neutralise the effects of hybrid mismatch arrangements"*.

Insurance Europe supports the aim of the Organisation for Economic Co-operation and Development (OECD) base erosion and profit shifting (BEPS) project to address weaknesses in the international tax environment, and recognises the OECD's concerns that some hybrid instruments can lead to base erosion. However, we are concerned that the proposed OECD rules on hybrid instruments will impact the hybrid regulatory capital of insurers. The hybrid regulatory capital issued by insurers is not designed to create tax mismatches and its use does not constitute a harmful tax practice. If this were to be impacted by the proposed OECD rules, not only would it have a disproportionate administrative burden, but it could increase the cost of raising capital and adversely affect the competitiveness of the insurance sector.

For the insurance sector "hybrid" instruments are essential for regulatory and commercial reasons as insurance companies use these instruments to meet their regulatory solvency and capital adequacy requirements. Virtually all major European insurers have issued such instruments in the market, with a total issuance greater than €10 billion[1] in 2013 alone.

Insurers reap the following benefits when issuing hybrid instruments: (1) hybrid instruments allow insurers to raise capital in a cost efficient way as debt carries less risk for the investor and, as a result, provide a cheaper form of capital than equity; (2) hybrid instruments enable an insurer to raise "risk" capital without having to issue equity and thereby diluting existing shareholders; and (3) despite their features which combine debt with equity characteristics hybrid instruments are typically bought by fixed income rather than equity investors. As a result, hybrid capital instruments broaden the investor base for regulatory capital instruments for insurers. For these main reasons,

[1] "Bank and insurance hybrid capital", January/February 2014, page 11.

Insurance Europe aisbl
rue Montoyer 51, B-1000 Brussels
Tel: +32 2 547 5811 • Fax: +32 2 547 5819
www.insuranceeurope.eu

Insurance Europe strongly believes that both external (widely held and/or traded) and intra group hybrid capital issued for regulatory (and rating) purposes in the insurance sector should be explicitly exempted from the OECD rules as they are issued for non-tax purposes and cannot be in any case regarded as tax abusive.

If, despite the above concerns, a full carve out of regulatory hybrid capital is not possible then Insurance Europe believes that at the very least the following points should be considered as a matter of priority:

- The overall approach of the scope should use a "bottom-up approach". The "top down" approach is widely drawn and would result with practical difficulties in how to avoid catching innocent commercial transactions. This being said, a "top down" approach would not be manageable for both the tax authorities and the insurance companies. The necessary carve-outs would have to be absolutely correct, complete and maintained more or less "real time"

- Debt issued on the capital markets with no connection between the issuer and the external investor should not be regarded as tax abusive. Therefore and in line with the discussion draft, the hybrid financial instrument rules should only apply to related party holdings.

- A 10% threshold for the test for related party status would be too broad. There would be significant identification difficulties if the 10% threshold is maintained. Instead of this, in Insurance Europe's view the related party limit should be set at a controlling interest level. An alternative in identifying whether there is a related party would be to consider whether GAAP consolidation is required

Following these recommendations could be a way to tackle the abuse of hybrid instruments without imposing unwarranted restrictions on the tax deduction for interest on regulatory hybrid debt issued by insurers. In the below, we further clarify our position by answering the questions on hybrid instruments put forward by the OECD Discussion Paper in box 2.

Specific Comments

<u>1. Is it clear what elements need to be present in order for the rules neutralising hybrid financial instruments or hybrid transfers to apply?</u>

The OECD discussion draft defines a hybrid financial instrument as "*any financial instrument (including a hybrid transfer) where a payment made under the arrangement is deductible in the payer's jurisdiction but not included by the recipient as ordinary income when the recipient calculates its net income for tax purposes*."

In Insurance Europe's view the term "ordinary income" might result in uncertainty when applying a test which instrument is regarded as hybrid. For example, the recipient jurisdiction may subject the item to a different tax rate or certain limitations from those that apply to ordinary income.

<u>2. Is the outcome of the rules' operation clear?</u>

Insurance Europe believes that the "outcome" of the rules' operation is not sufficiently clear. As a general remark, Insurance Europe believes that any rules concerning cross-border hybrid mismatches are inherently complex and require the full understanding of the tax treatment in two or even more countries.

Against this background, the discussion draft proposes an extremely broad and complex set of interrelated rules applying to different categories of transactions using primary and secondary "linking" rules. Furthermore several definitions which are important for the scope of the rules are unclear (widely held, related parties, ordinary income etc.)

Moreover, under the proposed rules, individual countries are given discretion to define the scope of the rules in important areas, such as the scope of transactions covered by the rules on hybrid instruments and the extent to which an item is defined in ordinary income. Insurance Europe is concerned that this might result in country-to-country variations of the scope.

It is therefore important that tax authorities introduce domestic legislation that is consistent and that there is a mechanism in place to deal with situations where there is taxability in one jurisdiction and no relief in the other – it is as important to avoid double taxation as double non-taxation.

3. Are there any arrangements which should be caught by the rules but are not addressed in the recommendations?

Insurance Europe is not aware of any arrangements which should be caught by the rules but are not addressed in the discussion draft.

4. This document sets out two possible approaches to drafting a scoping rule and summarises the possible advantages and disadvantages. Are the advantages and disadvantages accurately described and are there any other advantages and disadvantages of the two approaches?

Our response to this question is included under 5(b).

(a) What is the perceived impact of a bottom-up or top-down approach in terms of tax compliance and tax administration?

The discussion draft identifies two alternative approaches for defining the scope of the hybrid instrument rules: a "bottom-up" approach and a "top-down" approach. Under the bottom-up approach, the rules would apply to (i) instruments held between related parties, and (ii) instruments entered into as part of a tax-motivated "structured" arrangement. Under the top-down approach, the rules would apply to all transactions involving hybrid instruments, with certain limited exceptions (eg, instruments widely-held by unrelated parties).

As described above, the overall approach of the scope should use a "bottom-up approach". The "top down" approach is widely drawn and would result with practical difficulties in how to avoid catching innocent commercial transactions. This being said, Insurance Europe recommends that the definition of hybrid instrument be limited to investments in debt or equity of a related party. This would, by definition, limit the rules to related-party transactions.

5. This part includes a number of examples:

(a) What commercial or legal difficulties might these examples give rise to where the parties to an arrangement are unconnected and have no knowledge of the counterparties position?

The answer to this question is covered in our response to questions 6 and 8.

(b) In this context are there any examples or situations that are more problematic than others? If so please explain why problems arise and what constraints or restrictions the parties might face in obtaining relevant information on the treatment of the counterparty?

Insurers invest the premiums received from policyholders in a broad range of instruments. With a "top down" approach there would be a significant and unreasonable compliance burden to expect insurers to review all their investments and to identify the tax treatment in the issuers' jurisdiction(s). This is particularly so as the scope of "instruments" covered by the proposed rules is very broad. However, with a "bottom up" approach there would not be the same problems provided that the related party limit was increased to a more appropriate level to ensure insurers' portfolio holdings are not related parties.

There would be a further problem where the profits and gains of a particular class of insurance business is exempt from tax. Life insurers invest in hybrid instruments for commercial investment purposes to support policyholder liabilities.

Insurance Europe therefore suggests that there should be no requirement to identify the "ordinary income" where hybrid instruments are held to support the business of life insurers where in practicable terms the income of that business is exempt from tax. Failure to do this might result in life insurers ceasing to make such investments, because of concerns around tax compliance failures, which may result in a negative impact on capital markets.

(c) To the extent that there are difficulties, do these apply equally to both the holder and issuer in the context of hybrid financial instruments?

The discussion draft rightly notes that in case only investors would be subject to the proposed rules, information reporting might nevertheless be required also by issuers. Therefore, we recommend that in case of externally issued regulatory hybrid capital by issuers both, parties should be excluded from the rules. However, the difficulties for issuers would be greater, because in most cases it would be nearly impossible for them to identify the holders of insurers' regulatory hybrid capital for the reason given in our response to question 6. In contrast, the holder would at least know it had a holding in an insurers' regulatory hybrid capital, even though they would not necessarily know the tax position of the issuer.

Even if an insurer could identify all related parties holding its regulatory capital, it would be extremely difficult to assess the amount of relief. It is possible that a holder may not be a related party for a whole year, therefore the amount of relief would vary overtime and create uncertainty for an insurer.

Significant difficulties would also arise for insurers as investors. Insurers invest the premiums received from policyholders in a broad range of instruments. With a "top down" approach there would be a significant and unreasonable compliance burden to expect insurers to review all their investments and to identify the tax treatment in the issuers' jurisdiction. This is particular so as scope of "instruments" covered by the proposed rules is very broad. However, with a "bottom up" approach there would not be the same problems provided that the related party limit was increased to a more appropriate level to ensure insurers' portfolio holdings could not be related parties.

<u>(d) Are there any other situations or examples, not covered here that give rise to difficulties? In particular are there any specific problems for regulated businesses (see also Q. 8 below)?</u>

Where an insurer issues regulatory hybrid capital externally there will be a large number of holders of that capital. Usually more than one tranche of regulatory hybrid capital will have been issued, therefore the total number of holders of an insurers' regulatory hybrid capital will be large.

Therefore, unless externally issued regulatory hybrid capital is carved out from the hybrid financial instrument rule, in addition to the identification difficulties, to which we refer to in our response to question 6, there would be a significant administrative burden in ascertaining the tax treatment in each holder's jurisdiction. This would be disproportionate, particularly in view of the fact that insurers' regulatory hybrid capital is not designed to create a tax mismatch.

<u>6. What definition could be used to capture the concept of widely-held or regularly traded whilst also addressing concerns that any exemption should not be available to related parties, parties acting in concert or parties to a structured arrangement (i.e. an arrangement designed to obtain the benefit of a mismatch).</u>

In our response to the above questions, Insurance Europe would like to comment on regulated hybrid capital externally issued by insurers. Insurance Europe's comments on internally issued regulatory hybrid capital by insurers are covered in question 8.

The discussion draft in paragraph 160 (page 42) assumes that that Additional Tier 1[2] instruments issued directly to the market are unlikely to be caught by either a related-party hybrid mismatch rule, or a more widely drafted rule that contains a specific carve out for 'widely-held' or 'traded' instruments. As further elaborated below, in our view this might be too optimistic and not correct with respect to externally issued external regulatory hybrid capital by insurers.

Even under the "bottom-up" approach externally issued regulatory hybrid capital by insurers can be caught by the 10% related party test threshold as insurance companies may have portfolio holdings where the percentage of the share capital held exceeds 10%. A life insurer receives substantial premiums from policyholders which it invests to support policyholder liabilities. The size of the premiums invested means that it is not unusual for life insurance companies to have what are properly regarded as portfolio holdings where the percentage of the share capital held (or the interest held via an investment fund) exceeds 10%, being the proposed related party test threshold in the discussion draft.

[2] "Additional tier 1" is a concept used under Basel 3; under Solvency II, the comparable type of instruments are called "restricted tier 1" instruments. Even though the instruments will differ, we use both terms synonymously.

According to the OECD discussion draft, once an investor is classified as a related party, an insurer would be obligated to obtain relevant information on the tax treatment of these instruments in the tax statement of the investor. As mentioned above, in the context of externally issued regulatory hybrid capital by insurers, this would be nearly impossible.

Regulatory capital hybrid instruments issued by insurers are typically placed in the market in the form of bonds. These instruments are sold to international investors via banks, which buy the bonds from the issuer and immediately sell them to investors. Therefore, in principle there is no direct contact between the issuing insurance company and the investors.

Furthermore, even on the day of pricing of a new transaction the issuing insurance company has only incomplete information on the identity of the bond investors for several reasons. For example large investment funds buy bonds in their name, but then distribute them to various funds (potentially based in various countries) with no information available to the issuer.

Similarly to the primary market, on the secondary market the issuers have no insight on the trading activities. There is no requirement to hold a register of the owners of the externally issued regulatory hybrid capital. There is therefore no comprehensive record of the current holders of regulatory hybrid capital.

Also during the payment process, there is no direct contact between issuer and holder because the issuers typically employ paying agents (banks) to receive coupon and principal payments. After receiving the payments from the issuer the paying agent forwards them to the clearing system which then forwards the payments to the various depository banks, which then process the payments to investors.

Furthermore, as the level of shareholding is likely to change over time, an insurer would be required to permanently monitor who owns its shares and securities as well who owns its regulatory hybrid capital. This would create a disproportionate administrative burden for instruments that cannot be regarded as tax abusive.

Finally, assuming that an insurer could identify all related parties holding its regulatory capital, it would be extremely difficult to assess the amount of relief. It is possible that a holder may not be a related party for a whole year, therefore the amount of relief would vary overtime and create uncertainty for an insurer.

Because of these reasons, in most cases it would be virtually impossible for an insurer to identify the holder of its regulatory hybrid capital and to fulfil any requirements to prove that payments are included in the taxable income of the holder of these instruments.

Therefore, we strongly recommend that all (both unrelated and related party) external regulatory hybrid capital issued by insurers is carved out from the rule. This is because it will in most cases be nearly impossible for insurers to identify all the holders of their externally issued regulated hybrid capital and the tax treatment in the holder's jurisdiction.

If it is not possible for there to be a complete carve out for regulatory hybrid capital of insurers then we would strongly recommend that a "bottom up" approach is taken and:

- Only related party holdings are included.
- The related party limit is set at a level that would not capture insurers' portfolio holdings. This would also have the benefit that it would exclude the vast majority of parties who are related simply because they have a minority shareholding in an insurer.

As regards the related party definition, Insurance Europe believes that if the definition was that of a controlling interest then it is highly unlikely an insurer would have any difficulties identifying related parties. Insurance Europe acknowledges that some jurisdictions may regard controlling interest as being too high.

An alternative to identifying whether there is a related party would be to consider whether GAAP consolidation is required. The benefit of this is that it would be based upon objective tests that groups have to apply in drawing up their statutory accounts. It would also ensure that the rule is targeted at situations where there is genuine (and purposeful) economic connectivity between the parties genuine. We believe that this addresses the situations set out

in paragraph 128 of the discussion draft. Taking IFRS 10 ("consolidated financial statements") as an example, the key principals are that that control exists and consolidation is required, only if the investor "*has power over the investee, exposure to variable returns from its involvement with the investee and the ability to use its power over the investee to affect its returns"*. There should be a reassessment if facts and circumstances indicate changes to any of these elements.

The definitions of the ability to affect returns, exposure to variable returns and power over the investee are:

- Power over the investee

  "existing rights that give the current ability to direct the relevant activities". The relevant activities are those that significantly affect the investee's returns, such as voting rights, appointment rights etc.

- Exposure to variable returns

  Variable returns are returns that are not fixed and have the potential to vary as a result of the performance of an investee, eg dividends, management fees and returns not available to other investors.

- Ability to affect returns

  This considers the interaction between the first two steps, namely whether the investor has the ability to use its power to affect the investor's returns from its involvement with the investee. The key consideration when assessing investment funds is whether the investor is a principal or agent. It is acting as principal that is important, ie acting on its own account and not that of another party. Consideration here is given to such as scope of authority, rights held by third parties and remuneration.

<u>7. If the rule exempted certain traded instruments then how could it be drafted so that it still applied to structured arrangements and 8. In relation to regulatory capital</u>

<u>(a) What are the regulatory requirements for banks' to issue/manage capital at top holding company level, and what arrangements are used to pass this down the group? For example, what use is made of identical and traceable instruments and under what conditions would the arrangement be funded by a market issuance at top holding company level?</u>

According to the discussion draft, as a result of regulatory requirements, banks are encouraged by regulators to raise capital through so called "single point of entry" resolution, where loss absorbing capital is issued at top holding company level and then passed down through the group to the relevant subsidiaries.

Insurance Europe would like to underline that a similar situation exists in the insurance sector. In the context of insurance, different commercial factors that might impact on the decision on where to issue regulatory hybrid capital include regulatory aspects, taxing considerations and the issuers policy regarding its approach to capital markets under Solvency II, instruments issued by group members other than issued by the entity which heads the group are deemed to be unavailable – and thus ineligible – for group capital purposes. While there are potential exemptions to these standard rules, some groups will be forced to execute all external hybrid capital issuance from the entity which heads the group level.

In addition, rating agencies favour issuance of hybrid capital instruments by the entity which heads the group - according to the agencies' insurance capital methodology. As a result of these considerations regulatory hybrid capital might be issued externally by the entity which heads the group for other companies in an insurer's group.

Furthermore, whether there is an external issue will depend on the overall capital and funding situation of the group. For example, if the group has sufficient cash and regulatory surplus at the group level and there is commercial and regulatory need for hybrid capital at the level of a subsidiary, this will be achieved through intra-group transfers. Such intra-group transfers should not be subject to hybrid mismatch rules.

Therefore, the issue of regulatory hybrid capital because of regulatory requirements and is not issued to create tax mismatches. As such, Insurance Europe believes that where regulatory hybrid capital is issued for regulatory purposes, intra-group issues should be carved out in addition to those issued externally. So there should be a full

carve out for insurers' regulatory hybrid capital unless structured arrangements are involved. If the full carve out is not possible, the hybrid financial instrument rules should be limited to intra-group hybrid debt where it cannot be evidenced that the holder of the instrument is subject to taxation on the income.

(b) Are special provisions needed to create parity between a banking group issuing hybrid regulatory capital indirectly to the market through its holding companies and a banking group (or another industry group) issuing hybrid regulatory capital directly to the market?

The answer to this question is covered in our response to question 7(a).

(c) Are hybrid regulatory capital instruments sufficiently different as to justify a full carve-out from hybrid mismatch rules? Are there inherent safeguards in place against the use of these instruments for tax-planning purposes or what safeguards could be introduced to ensure that any exemption from the general hybrid mismatch rules could not be abused?

The regulatory hybrid instruments issued for both internal and external purposes are very different compared to other hybrid instruments.

Insurers' regulatory hybrid capital forms an integral part of the capital of insurers and is therefore essential in supporting the trading operations of the insurance industry. Although, all industries require capital to operate, insurers are required to hold their capital subject to specific regulatory rules.

The issue of hybrid regulatory capital is driven by regulation. Insurance groups are required to meet capital adequacy standards and the hybrid regulatory capital which can count towards their capital has certain equity-like features mandated by the local regulators (or the European regulators when Solvency II comes into effect in 2016) relating to loss absorbency and interest deferral.

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