Position Paper

Insurance Europe comments on the OECD's discussion draft: BEPS action point 4

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Introductory statement

Insurance Europe welcomes the opportunity to comment on this OECD discussion draft on interest deductions and other financial payments. Insurance Europe supports the aims of the OECD Base Erosion and Profit Shifting (BEPS) Action Plan to address weaknesses in the international tax environment. Consequently, Insurance Europe also supports the objectives of the discussion draft to address BEPS practices using interest and economically equivalent payments.

General comments

1. Insurance Europe welcomes the acknowledgement in the discussion draft that a different approach is required for the financial sector in light of its particular circumstances and regulatory/operating environment. Requiring tax treatment that is inconsistent with the sector's regulatory position would undermine the OECD's stated policy aim of disallowing only those deductions which are used to achieve BEPS. Insurance Europe agrees that existing regulatory requirements act already as an effective limitation rule for the insurance sector.

2. Therefore, Insurance Europe's **first preference** would be for insurance company interest to be excluded from the scope of BEPS Action 4.

3. In the absence of this blanket exclusion, Insurance Europe sees as a **second best solution**, a role for targeted rules (due to the very material difference of leverage ratios in the (life) insurance industry compared to other industries); best practice should allow territories the flexibility to use and adapt existing rules with a proven track record - including arm's length rules.

4. Given that most insurance groups are net interest recipients, as **a third best solution** a fixed ratio approach may be appropriate for the sector, as long as it is applied on a territory by territory basis, is

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set at the right level and by reference to the right measure and provided that the ratio test is not so restrictive that it effectively abandons the arm's length principle.

5. In any case, Insurance Europe sees that there is an important issue that has to be solved with the proposed scope of the discussion draft's interest rules presented in **Paragraph 35** (i.e. interest on all forms of debt, payments economically equivalent to interest and expenses incurred in connection with the raising of financing). There has to be a precise carve-out for all payments linked to the insurance business; possibly there has to be a positive list of interest that has to be taken into account when computing the allowed interest deduction.

6. Insurance Europe disagrees with the approach proposed in **Paragraph 211** on the basis that a group-wide solution is not appropriate for the insurance industry.

7. The scope of any limitation of interest deductibility should be restricted to the tax policy concerns identified in **paragraphs 3 and 10** of the discussion draft — debt funding of inbound and outbound investments by groups. Therefore, the discussion draft should consider whether any tax policy concerns arise, for example, (i) where the borrower and the affiliate that uses the loan proceeds are in the same country or (ii) where the interest-payer is located in a country that has a tax rate that is equal to or lower than the tax rate in the country in which the affiliate receiving the interest is located (if the interest is otherwise subject to tax).

8. Europe is an important centre of insurance and reinsurance, with London, Köln, Munich and Zürich being worldwide centres of excellence and many European insurers have worldwide prominence. Paradoxically, a rule that limited interest deductions in such European locations may have the undesired effect of effectively enhancing the competitiveness of competitors based in tax haven territories, and hence running directly contrary to the purposes of the wider OECD BEPs project.

Difference between Banks and Insurers

9. **Paragraphs 203-208** of the discussion draft identify several ways in which banks and insurance companies differ from companies in other industries. However, there is another important difference that should be considered. Insurance company regulations generally make it difficult, as a practical matter, for insurance operating companies to borrow directly to meet their capital needs. Instead, it is routine to have a holding company engage in debt financing and then contribute the proceeds to the insurance company subsidiary. Any interest disallowance rule designed to address holding company affiliated debt should take into account this fact. Excluding dividend income from the definition of earnings as proposed in **paragraph 155** would, therefore, also negatively impact (insurance) holding companies.

10. **Paragraph 206** overlooks a crucial difference between banks and insurers. The (re)insurance business model has specific features that makes it less dependent on attracting capital from external sources. Insurance is funded by premiums which are paid up front, which provides insurers with strong operating cash-flow and reducing the need for requiring wholesale funding.

Role of Regulatory Capital

11. As acknowledged in **paragraph 208**, insurance companies worldwide are subject to strict regulations. Solvency II (and prior to 1 January 2016, Solvency I) requires insurers to hold an appropriate amount of capital in order to ensure that claims can be paid out to policyholders (while Solvency II applies only

in the EU, many other OECD member governments will implement new regulatory rules that follow the same fundamental concepts as Solvency II).

12. Furthermore, it is common for regulators to impose a further "buffer" or margin over and above the minimum capital requirement. Again, the insurer has no choice in this matter as it needs an insurance licence to do business and if it does not meet the regulator's requirements that licence will be withdrawn. Similarly, the insurer often has no choice over the legal structure it must adopt in a particular jurisdiction. Some regulators may allow a permanent establishment, others may require a subsidiary.

13. Regulatory capital exists to ensure that policyholders are protected in the eventuality of insurers having insufficient funds to meet claims. It is not meant to benefit insurance company shareholders. Capital is needed, but it is a scarce resource and it is therefore expensive. In the insurance sector this is exacerbated by the regulatory requirement from regulators to hold high quality capital (i.e. capital in the form of assets that are more secure and therefore more expensive to hold). Insurers need to strike this balance between the demands of regulators and ratings agencies to hold relatively large amounts of capital and the fact that holding capital is expensive.

14. As with all companies, there is an optimum capital structure under which insurance companies aim to operate. Although more expensive than senior debt, regulatory debt instruments are significantly cheaper than equity.

15. In addition to this regulatory aspect, rating agencies also assess both quantity and quality of capital. Insurers and reinsurers receive a credit rating. This has a substantial influence on the desire of insurance brokers and clients to place business with that insurer or reinsurer, and on the premium they would pay to do so. Rating agencies, in a similar manner to regulators, place limits on the quantum and quality of regulatory debt that insures can issue and which rating agencies assess as capital rather than ordinary liability in their models.

16. It can be concluded that regulators and rating agencies effectively force insurers to hold high quality capital in excess of expected liabilities, and importantly limit the amount and type of debt that may be included in regulatory capital. Maintaining the required level of capital in a particular entity is, therefore, not a question of choice but is rather critical to an insurer's ability to do business.

17. **Paragraph 209** states that due to the focus on net interest income, the general interest limitation rules set out in the draft would not be an effective instrument at addressing any base erosion and profit shifting risks presented by insurance companies. Example 7 (**paragraph 253**) "Application of a group-wide rule to groups with net third party interest income" states that insurers are usually recipients of net interest income. They would, therefore, be negatively and unjustly affected by general group-wide interest rules. Insurance Europe shares this point of view and, therefore, strongly recommends excluding insurance companies from a tax rule that limits interest deductibility. Given the role of regulatory capital, an exemption for the insurance industry is possible without endangering the goals of BEPS respectively action point 4.

Paragraphs 211 and 212

18. **Question 34** of the discussion draft asks: *"Regulatory capital may be described as performing a function for financial sector groups comparable to that of equity and debt for groups in other sectors. How could a general rule be made to apply to the interest expense on a group's regulatory capital*

without having an undue impact on the group's regulatory position (for example, by limiting a group's net interest deductions on regulatory capital to the level of its interest expense on instruments issued to third parties)? ". Two possible approaches are then proposed in **paragraph 211** and **paragraph 212.**

19. **Paragraph 211** proposes the design of a group-wide allocation rule which limits total net deductions on regulatory capital (ignoring the interest income generated from using the capital to write business).

20. Insurance Europe believes that the option described in **Paragraph 211** would not be suitable to address the specific conditions in the insurance sector. Our understanding of the proposed rule is that it would limit a group's total net deductions on its regulatory capital to the amount of interest paid on these instruments to third parties and that in the respective calculation the interest income generated from using the capital to write business should be excluded.

21. Insurance Europe would first point out that such an approach would not be feasible as it is not possible to build up a link between the liability side and specific asset position. Therefore, it would not be possible to assign interest income from capital used to write business to specific position of the regulatory capital. The prime purpose of regulatory capital is to ensure that the insurer, across a range of the most severe loss scenarios it is potentially exposed to, has both sufficient capital and liquid funds to be able to pay all claims due to all entitled policyholders under all those scenarios.

22. But more importantly, Insurance Europe must emphasise that tax relief for interest on regulatory debt is of great importance to the insurance sector. Tax relief on the interest cost of issuing regulatory debt is a key factor in an insurer's calculation of its cost of regulatory capital. Control by regulators over the amount of capital held and the impact of the quantity and quality of regulatory capital on ratings make it an unlikely arena for BEPS activity — whereas uncertainty over the deductibility of interest on regulatory debt financing would likely increase the cost of insurance, and potentially create an impediment for the sector in accessing capital markets.

23. Finally, there would be a risk that the findings of the OECD report on action 2 "neutralise the effects of hybrid mismatch arrangements" would be contradicted. This is because it would easily be possible that instruments which had been excluded intentionally from any restriction under action 2 would fall under the new rule proposed in **paragraph 211** of this discussion draft.

24. **Paragraph 212** proposes that a best practice approach could focus on a group's interest expense other than that on its regulatory capital. This may comprise targeted rules to address risks posed by specific transactions.

25. It also raises the possibility that existing non-tax regulatory capital requirements imposed by banking and other regulators on banks and insurance companies could "act as an effective general interest limitation" both in preventing excessive leverage and shaping the financing structures of insurance groups. Insurance Europe strongly agrees that this is the case and suggests that (at least regulated) insurance groups, sub-groups and companies should be excluded from a tax rule that limits interest deductibility.

26. Then, targeted rules could apply, as suggested on **page 63** of the discussion draft, but they would only cover interest paid by non-insurance affiliates.

27. Insurance Europe reiterates that its first preference is for interest paid as part of insurers' ordinary capital structures and business operations to be excluded from any limitation. If there are any specific

transactions relating to interest expense which are seen as posing BEPS risk other than in respect of regulatory capital, best practice should require these are addressed by specific targeted rules.

28. Given that insurers are usually recipients of net interest income (as noted in the discussion draft at **paragraph 205** as well), Insurance Europe think that this allows insurers to be covered by a general approach, such as a fixed ratio rule, without an undue impact on a group's regulatory position but only as long as the rule is applied on a territory by territory basis, is set at the right level and by reference to the right measure and provided that the ratio test is not so restrictive that it effectively abandons the arm's length principle. Where this ratio is exceeded, a carve-out should be applied where it can be demonstrated that the level of interest paid satisfies an arm's length test. Targeted rules could then address any remaining issues, by reference to specific transactions which are perceived as posing a BEPS risk.

29. It should also be borne in mind that some potential risks may be addressed by approaches developed under other BEPS Actions — in particular through the development of the CFC rules or via the treaty abuse rules, that would prevent treaty relief from withholding tax on interest paid for abusive reasons. Insurance Europe would also recommend that any such rules are developed to apply on a territorial, rather than an entity basis, not only to help provide consistency across different territories but also to reduce any disproportionate compliance burden both for companies and government officials.

30. Insurance Europe believe that such an approach would be commensurate with the very limited BEPS risk posed by interest payments made by the insurance sector given the particular regulatory and commercial environment in which it operates.

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