Position Paper

Insurance Europe response to the OECD consultation on approaches to address BEPS involving interest in the banking and insurance sectors

Our reference:	ECO-TAX-16-107	Date:	1 September 2016
Referring to:	OECD discussion draft on approaches to address BEPS involving interest in the banking and insurance sectors		
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Pages:	6	Transparency Register ID no.:	33213703459-54

Introductory comment

Insurance Europe welcomes the opportunity to comment on this Organisation for Economic Co-operation and Development (OECD) discussion draft on approaches to address Base erosion and profit shifting (BEPS) involving interest in the banking and insurance sectors. Insurance Europe supports the aims of the OECD BEPS Action Plan to address weaknesses in the international tax environment, as well as the OECD's reflections on how interest limitation rules can be designed to take into account the particularities of the financial sector in general and of insurance in particular.

Summary

The OECD recognises in paragraph 26 of the Discussion Draft that "excessive leverage in an insurance company has not been identified as a key risk at this point in time and so it is anticipated that, in the majority of cases, this BEPS risk will be low". In addition, the OECD acknowledges that existing regulation acts as a safeguard for any insurance BEPS risk. Insurance Europe agrees with and welcomes these statements.

Therefore, Insurance Europe believes that general rules should apply to insurers, and in particular to entire insurance groups when relevant. If tax authorities are concerned about specific insurance structures from a BEPS perspective, targeted rules can complement the general interest limitation rules and would be the most effective way to address these issues. Otherwise, applying special rules regardless of the very low BEPS risk in insurance would result in inappropriate restrictions.

However, the OECD proposes a fixed ratio rule which, while applicable to local groups, would not apply to insurance companies which are part of this group. Therefore, the application of the fixed ratio rule is limited to the non-insurance companies of an insurance group and the OECD suggests that this is done by excluding insurance-related revenue and debt. The OECD is right that excluding banks or insurance companies would

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have the same effect as applying a fixed ratio rule to these entities, but Insurance Europe does not agree with how the OECD proposes to implement this rule.

The consequence of the OECD's proposals would be that the interest income and operating profit of insurers would be excluded whereas the full amount of interest expense on debt issued at holding level would remain under the scope of the rules. Insurance Europe believes that this approach is flawed. Where typically the activities of an insurance or banking group are predominantly insurance-related, this approach leaves very limited or no EBITDA in the non-insurance part of an insurance group. As a result, non-insurance companies (including holdings) that are part of an insurance group could be faced with an unintended interest limitation. This situation differs from non-financial groups for which, under a consolidated approach, the main source of earnings that constitutes the basis for determination of the interest deductibility is included when applying the fixed ratio rule.

While for other industries consolidated approaches in any form are appropriate, applying a fixed ratio rule to the non-insurance part of an insurance group is not. Only where the insurance activities of a group are less than predominant could such a rule be suitable. So, as a first step, prior to applying any fixed ratio rule, it would need to be determined whether the activities of the group predominantly consist of insurance activities. Only if not, the modified fixed ratio rule could be applied.

Many European insurers have a non-financial holding company. Insurers often issue regulated debt out of this holding company and may use the debt to subscribe for equity in the insurance undertaking (as equity is considered higher-quality capital by regulators). Furthermore, the company in which the equity has been invested could be in the same territory as the holding company that has raised the debt. Carving out the insurance undertaking would remove the interest income and operating income from the EBITDA calculation, which Insurance Europe believes could lead to inadvertent interest restriction. Specifically, many insurance groups would have a negative EBITDA and most interest would therefore not be deductible.

If general rules are not applied to insurers as suggested above, Insurance Europe believes that this risk of inadvertent interest restriction can be partially mitigated by strengthening paragraph 56 of the Discussion Draft. The recommendation in paragraph 56 should automatically exclude all third-party interest expense on all debt issued by a European company whose activity is mainly or entirely insurance or related activities. This recommendation should also apply in the same conditions to groups where insurance entities and bank entities are related.

Answers to consultation questions

Question 1: Are there any categories of BEPS risk involving interest posed by banks or insurance companies, or entities in a group with a bank or insurance company, not identified in the discussion draft which should be focused on as part of this work? If so, what are these risks and how could they be addressed (either through the approaches set out in this discussion draft or otherwise)?

Question 3: Are there other any general issues related to the impact of regulatory capital rules on the level of leverage in a bank or insurance company that should be taken into account? It should be clearly identified where these are issues relevant to all or a large number of countries or where they concern a particular country's regime.

The OECD acknowledges that existing regulation acts as a safeguard for any insurance BEPS risk. In Europe, this refers primarily to the Solvency II Directive which applies to all insurers. Solvency II limits the amount of debt an insurer can hold to meet its regulatory capital requirements. These limits apply to all capital tiers at both group and subsidiary level. If any limits imposed by Solvency II are breached, the excess debt would provide no capital benefit. Insurance Europe believes that Solvency II also provides adequate safeguards to BEPS activity and welcomes the OECD's recognition that the potential BEPS risk in insurance is low. Insurance

Europe believes that these considerations apply to all companies in an insurance group which is subject to group regulation.

While the above refers primarily to the regulatory environment in Europe, it should also be noted that many other jurisdictions are developing regulatory rules that follow the principles of Solvency II and that will therefore most probably be considered equivalent to Solvency II. In addition, European insurers who reinsure in non-EU jurisdictions are asked to demonstrate that regulation in those jurisdictions is equivalent to Solvency II.

While the OECD acknowledges that existing regulation acts as a safeguard for any insurance BEPS risk, it also states that this role is limited by inconsistent regulatory frameworks between various jurisdictions. Insurance Europe would point out that there is a significant effort ongoing to harmonise regulation internationally and regionally, for both banks and insurers. Therefore, this concern is unfounded.

The OECD's Discussion Draft also raises the issue of "hybrid" capital which can be treated as equity for regulatory purposes and as debt for tax purposes and which could escape interest limitation rules. Insurance Europe would point out that regulation such as Solvency II places an upper cap on the amount of hybrid capital which can be issued for regulatory purposes, so this effectively restricts any BEPS risk. In any case, it should be acknowledged that hybrid regulatory capital is not designed to create tax mismatches and its use does not constitute a harmful tax practice.

Question 5: Are there any concerns raised by a country not introducing tax rules to deal with excessive interest deductions in banks and/or insurance companies including permanent establishments, if the country has established that no material BEPS risk exists (which may be as a result of the operation of regulatory capital rules)?

Insurance Europe believes that, if it is accepted that insurers pose a low BEPS risk, general rules should apply to insurers rather than no rules at all. If tax authorities are concerned about specific insurance structures from a BEPS perspective, targeted rules can complement the general interest limitation rules and would be the most effective way to address these issues. Applying special rules regardless of the very low BEPS risk in insurance would result in inappropriate restrictions.

Question 6: What approaches currently applied by countries would be effective in reducing BEPS risks posed by over-leverage in banks and/or insurance companies including permanent establishments, if a country identifies that such a risk exists? These may be sector specific rules or rules which apply to all sectors.

Insurance Europe is unaware of existing specific rules for insurers in any jurisdiction. This is probably because excessive leverage in an insurance company has not been identified. As explained above, if tax authorities are concerned about specific insurance structures from a BEPS perspective, targeted rules can complement the general interest limitation rules and would be the most effective way to address these issues. Applying special rules regardless of the very low BEPS risk in insurance would result in inappropriate restrictions.

Question 7: Are there any other practical considerations related to the application of the fixed ratio rule to banks or insurance companies that should be taken into account?

Insurance Europe has serious concerns with this approach.

The fixed ratio rule would apply to groups but would not apply to regulated insurance companies which are part of these group. The consequence of this proposal would be that the interest income (from the bond portfolios held by insurers) and operating profit (from the positive underwriting result) of insurers would be excluded, whereas the full amount of interest expense on debt issued at holding level would remain in scope.

Insurance Europe believes that this approach is flawed. Where typically the activities of an insurance group predominantly consist of insurance-related activities, this approach leaves very limited or no EBITDA in the non-insurance part of an insurance group. As a result, non-insurance companies (which includes holdings) that are part of an insurance group could be faced with an unintended interest limitation. This situation differs from non-financial groups for which - in a consolidated approach - the main source of earnings that constitute the basis for determination of the interest deductibility is included when applying the fixed ratio rule. Therefore, while for other industries consolidated approaches in any form are appropriate, applying a fixed ratio rule to the non-insurance part of an insurance group is not. Only where the insurance activities of a group are less than predominant could such a rule be suitable. So, as a first step prior to applying any fixed ratio rule, it would need to be determined whether the activities of the group predominantly consist of insurance activities. Only if not, the modified fixed ratio rule could then be applied.

Many European insurers have a non-financial holding company. Insurers often issue regulated debt out of this holding company and may use the debt to subscribe for equity in the insurance undertaking (as equity is considered higher-quality capital by regulators). Furthermore, the company in which the equity has been invested could be in the same territory as the holding company that has raised the debt. Carving out the insurance undertaking would remove the interest income and operating income from the EBITDA calculation, which Insurance Europe believe could lead to inadvertent interest restriction. Specifically, many insurance groups would have a negative EBITDA and most interest would therefore not be deductible.

Illustration: In this example, the two holding companies of an insurance group have negative EBITDA (which is not uncommon in insurance, as they incur management expenses and have no income but dividend income). Under the proposed carve-out of insurance companies, the local group will have net interest expense of EUR 60 million but no positive EBITDA. As a consequence, the entire interest expense of 60 will be disallowed, while without a carve-out the positive EBITDA of the operating group could be used in applying the fixed ratio rule, if the group would be in a net interest expense position.

EUR (million)	Holding Company 1	Holding Company 2	Operating company — regulated insurer	Local group
EBITDA	-25	-5	100	-30
Net interest income/expense	-45	-15	200	-60
Fixed ratio				30%
Interest capacity				0
Net interest income/expense of local group				-60
Total interest disallowance				-60
Allocation of disallowance	-45	-15		-60
Interest taxable/deductible	0	0	200	

If general rules are not applied to insurers as suggested above, Insurance Europe believes that this risk of inadvertent interest restriction can be partially mitigated by strengthening paragraph 56 of the Discussion Draft. The recommendation in paragraph 56 should automatically exclude all third party interest expense on all debt issued by a European company whose activity is mainly or entirely insurance or related activities and services (including asset management). This recommendation should also apply in the same conditions to groups where insurance entities and bank entities are related.

Question 8: Are there any other considerations with respect to the ability of banks and insurance companies to use interest to fund non-taxable income on an equity investment that should be taken into account?

While insurers do not usually borrow to make an equity investment, it is certainly the case that many insurance groups often raise debt at holding company level to support a subsidiary of the group (by way of passing down equity or boosting the group regulatory capital requirements). The use of equity rather than debt would in this case be a requirement of the regulator which would insist on using equity (i.e. the strongest, most loss-absorbing, type of capital).

Question 12: Are there any other general issues related to the level of BEPS risk involving interest posed by entities in a group with a bank or insurance company that should be taken into account?

The discussion draft gives two examples in paragraph 46 of instances in which insurers could engage in BEPS activity.

- **Where an insurance group includes entities in more than one country or are taxed differently.** European insurers are all subject to Solvency II regardless in which EU country they have entities. When European insurers have entities in non-EU jurisdictions, they are asked to demonstrate that regulation in those jurisdictions is equivalent to Solvency II. Therefore, Insurance Europe believes that no BEPS risk can arise in such situations.
- **Where an entity is part of the local group, but outside the regulatory group.** As explained above, this would be a situation best addressed through targeted rules, which would avoid any inadvertent impacts of a special rule for insurers.

Question 13: Are there any additional practical issues arising from the modifications to the fixed ratio rule described in the discussion draft, as it applies to an entity in a group with a bank or insurance company:

Application of the fixed ratio rule to a local group excluding banks and insurance companies. Just as Insurance Europe is concerned by the application of a fixed ratio rule to a group while excluding the insurance companies of this group, it has similar concerns about the suggestion to create a second local group containing only insurance subsidiaries and to apply the fixed ratio rule to that group. In this case as well, the majority of interest income and business profits would be removed from the interest limitation rules while leaving the full amount of interest expense on debt issued at holding level under the scope. As explained above, all third party interest expense on all debt issued by a European company whose activity is mainly or entirely insurance or related activities should be automatically excluded.

The treatment of interest expense on debt supporting banking or insurance activities. Although the OECD recognizes that non-deductibility of interest may not be appropriate in case of instruments that support regulated banking or insurance activities, the suggested mechanism to remedy this seems too narrowly calibrated because:

- Only interest on regulatory capital is excluded, while other types of debt may also support the banking and insurance activities.
- Only external interest is included.
- For non-regulatory instruments, the OECD suggest that BEPS should not be an issue if funds are lent on similar terms. However, in practice this may not necessarily be the case.
- The allocation approach as described in paragraph 60 seems discriminatory and would likely result in something that BEPS is trying to limit, namely tax-motived behaviour.

Insurance Europe believes that this discrepancy can be remedied by strengthening paragraph 56 of the Discussion Draft. The recommendation in paragraph 56 should automatically exclude all third party interest expense on all debt issued by a European company whose activity is mainly or entirely insurance or related activities and services (including asset management). This recommendation should also apply in the same conditions to groups where insurance entities and bank entities are related.

Question 15: Are there any additional practical issues arising from the approaches for applying the group ratio rule to an entity in a group with a bank or insurance company that should be taken into account?

Question 16: Are there any other approaches to applying the group ratio rule to an entity in a group with a bank or insurance company that should be considered?

Applying the group ratio rule to an insurance group while excluding insurance subsidiaries would yield a similar result as when the modified fixed ratio rule is applied (i.e. the majority of interest income and business profits would be removed from the interest limitation rules while leaving the full amount of interest expense on debt issued at holding level under the scope). Insurance Europe believes that the recommendation in paragraph 56 should automatically exclude all third party interest expense on all debt issued by a European company whose activity is mainly or entirely insurance or related activities. This recommendation should also apply in the same conditions to groups where insurance entities and bank entities are related. The best approach would be to apply the group ratio rule to the insurance group including insurance subsidiaries.

Question 17: Do you have any other comments on any of the issues raised by this discussion draft?

Insurance Europe believes that existing debt should benefit from grandfathering or at least from a transitional period which would allow for the most efficient restructuring of the existing debt, a big part of which is long-term.