Summary of concerns raised by the European insurance industry regarding the OECD BEPS Project

A position paper by Insurance Europe and the Tax Expert Group of PEIF member companies

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This paper is a summary of the European insurance industry's views related to the proposals put forward in the various discussion drafts published by the OECD as part of the *Action Plan on Base Erosion and Profit Shifting* (BEPS). The views in this paper also apply in the context of a separate initiative by the European Commission (the *Action Plan for a Fair and Efficient Corporate Tax System in the EU*), which will also be looking into (among others) revising transfer pricing or permanent establishment rules to better reflect modern business realities.

The European insurance industry fully supports the aims of the BEPS Action Plan to address weaknesses in the international tax environment. The industry has been involved in the consultation process on the Action Plan during the previous 18 months and will continue to be active in this area. Similarly, **the European insurance industry fully supports the objectives of the EC Action Plan to ensure fairer and more efficient taxation and to effectively tackle corporate tax avoidance**. The industry is looking forward to contribute to this effort in a constructive way.

Overview

In general, the industry's view of the several BEPS Actions which it considers directly relevant for insurers is that **problematic aspects arise when the proposals do not fully take into account the particularities of the insurance business model** and the central role that risk and capital play in it. **Insurers have a unique business model**: they take on risks from their customers (which are unrelated policyholders) in exchange for premiums determined according to the specific profile of the risks they insure. They promise to pay out in the future in the event that the insured loss occurs and they support this promise through capital which will be subject to strict regulation at European level (through Solvency II) and equivalent regimes in other territories.

Consequently, any discussion regarding the taxation of the insurance sector and any perceived avoidance **should take into account this very specific assumption of risk which is insurers' core activity and the regulatory requirement to hold the necessary capital to support the business written**. Generally, an insurer's "*risk assumption*" activities will fall within the category of underwriting, which is crucial in the decision to accept a particular insured risk (over which insurers themselves have no control) and thus

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essential for carrying out insurance business. For insurance groups, **the pooling and diversification of different categories of risk is crucial to their business**, and this often involves shifting risk across borders. Insurance is often written globally and insurers have to use both internal and external reinsurance and retrocession in the process of managing the risks they take on. *It does not follow that this transfer of risk is tantamount to BEPS*. Rather, it is the very nature of the insurance industry to transfer risk and to maintain capital in a single location to maximise pooling the diversification benefits.

In all jurisdictions **regulators require insurers to hold an appropriate amount of capital** in order to ensure that policyholder claims are paid out in all circumstances. This capital is akin to plant and machinery in the manufacturing sector and, absent this "plant and machinery", the insurer cannot operate. The precise amount of capital depends on the regulatory regime in question and the nature of the underlying risk. But in all situations, this will be the minimum amount of capital that is held by the insurer. In addition to regulatory capital, ratings agencies impose additional conditions to satisfy credit rating requirements. For insurers, the rating applied is critical as certain types of investors may only be able to invest in entities with a prescribed minimum credit rating and insurers and their brokers placing reinsurance will examine the reinsurer's credit rating very critically. Therefore, **the maintenance of an appropriate level of capital within a jurisdiction is not a business choice for insurers**, open to flexibility depending on tax treatment but instead *it is critical to insurers' ability to carry on business.*

Insurers must hold additional capital in excess of the minimum required amount as a buffer. The tension between the flexibility of this approach in writing business and paying out claims versus the cost of holding high-quality regulatory capital is something that insurers constantly have to manage. *The ability to manage capital efficiently is a key source of competitive advantage in the sector.* As long as the regulatory regime under which an insurer operates accepts the amount of capital held by the insurer as appropriate, the tax regime should also accept it as such. Should insurers' current operating models be impacted in such a way that the group would need to hold additional capital, this will have a clear economic cost, which may ultimately be passed on to consumers. Insurers perform a crucial role in Europe and absorbed much of the economic cost arising from large insurance loss events affecting Europe, e.g. the 2002 and 2013 floods and hailstorms in central Europe, the 1999 windstorms, the 1987 hurricane that hit the UK etc. It is crucial that this role is safeguarded.

The OECD has already made a considerable effort towards understanding these particularities of the insurance sector, namely the functions, assets, risk, and capital of the industry. This effort resulted in the development of Article 7 of the OECD Model Tax Convention and in the preparation of the *2010 OECD Report on the Attribution of Profits to Permanent Establishments* Part IV (Insurance) (henceforth "Part IV"). Part IV has been developed with stakeholder input and is supported by both the industry and tax authorities as a **reasonable and fair approach to taxing insurers**. Therefore, any measures that might decrease the effectiveness of Part IV in the context of the BEPS Action Plan should be considered with caution.

The interplay between the OECD's and the EC's corporate taxation proposals and existing or soon to be introduced European insurance regulation also needs to be carefully considered.
In the EU, insurers can conduct cross-border business under a *Freedom of Establishment* or *Freedom of Services* basis. This means in effect that EEA-based insurers may conduct insurance and reinsurance business in other EEA member states if they are authorised in their home state only. Therefore, **many insurance groups operate pan-European business** either through branches or direct sales. This reality needs to be taken into account when discussing elements such as CFC rules and cross-border reinsurance.

Under Solvency I and Solvency II, which will be introduced from 2016 onwards, insurance groups operating in the EU are **subject to regulation regarding capital adequacy on a group basis**. Along with setting the level of capital requirements, Solvency II will govern the assessment, quantification and disclosure of all types of risk an insurance group faces. Solvency II and equivalent regimes which are being implemented in other jurisdictions (such as Switzerland) **give specific credit to the diversification benefits that result from reinsurance** and take this into account when prescribing capital requirements. This must be considered when discussing elements such as risk transfer and the role of regulatory capital.

Key messages

I. Permanent Establishments

- Only the presence of key entrepreneurial risk-taking functions (KERT) should give rise to tax permanent establishments; profits are allocated for tax purposes dependent on where the KERT is located. In insurance, the KERT is with the person/entity that assumes and manages the insurance risk through underwriting and thus profit should be allocated to such function. If PEs are created in the location of non-KERT functions, a disproportionate compliance burden would result as numerous PEs could be created with no additional profits being attributed.

II. Risk transfer, transfer pricing and cross-border (re)insurance

- Insurers optimise and diversify their risk portfolio via intra-group transfers of risk through reinsurance. OECD BEPS and the European Commission’s corporate taxation initiative should not impinge on these arrangements.
- Income arising from risk assumption in a different territory to the location of the risk is not an automatic indicator of BEPS activity in insurance. This is merely a consequence of insurers managing risks on a global basis, including through reinsurance.
- CFC rules should not restrict the commercial operations of insurers and arrangements which are demonstrably required to optimise capital efficiency and to reinsure third-party risks.

III. Capital and interest deductions

- Existing regulatory requirements put an overall limit on the level of debt and hence interest deductions that an insurer can claim. Therefore, interest paid as part of insurers’ ordinary capital structures and business operations should be excluded from any further limitation.
- Any specific transactions relating to interest expense which are seen as posing BEPS risk other than in respect of regulatory capital should be addressed by specific targeted rules.
- Hybrid regulatory capital is not designed to create tax mismatches and its use does not constitute a harmful tax practice. On the other hand, this type of capital is very useful to insurers, for regulatory and commercial reasons. Therefore, hybrid regulatory capital should be exempted from any additional tax burden.

IV. Country-by-country reporting

- Enhancing the transparency towards tax authorities, streamlining of reporting requirements and the protection of commercially sensitive information have to be seen as equally important goals. Effective compliance with the new country-by-country reporting regime will require significant preparation and it is therefore important that companies receive clear and timely guidance regarding the definition of the data to be reported.
- Insurance business models are unique and this needs to be recognised when the information on the CbCR template is considered.

Detailed Comments

I. Permanent establishments (PE)

Through its work on **Action 7** of the BEPS Action Plan, the OECD is seeking to address concerns that some PE definitions can lead to base erosion. In this context, there is a risk that the OECD proposals might have significant unintended consequences for the insurance business model.

The key element in determining the establishment of a tax PE in a certain jurisdiction is the presence of *key entrepreneurial risk-taking* (KERT) activities in that jurisdiction. Part IV clearly recognised that - in insurance - **the KERT is with the person/entity that assumes and manages the insurance risk** through underwriting and that profits are allocated for tax purposes dependent on where the KERT is located. In contrast, functions such as sales and marketing of insurance, back-office processing of applications, administrative support, claims handling and investment management are not KERT functions and do not determine the attribution of risks and profits under Part IV nor drive regulatory requirements to hold capital against that risk assumption.

The OECD had initially proposed an insurance-specific option according to which an insurance company would have been deemed to have a permanent establishment in a country where premiums are collected by a dependent agent. It is most welcome that in its revised discussion draft on Action 7, the OECD effectively recognised the validity of industry concerns that **there should only be tax PEs for the insurance industry in jurisdictions where KERT functions are located.**

The industry also welcomes the recognition that Option B is preferable to other options outlined in the original draft, though Option B is still rather widely drafted. The proposed commentary on interpretation of these Articles would benefit greatly from recognition that the facts and circumstances of the business value chain should be taken into account as part of the determination of whether there is a PE. This is essential to ensure that numerous PEs are not created in circumstances where no additional profit would be attributed and that PE definitions for tax and regulatory purposes are aligned.

A separate concern not fully addressed by the revised discussion draft on Action 7 relates to wording in Article 5(5) which states that *"only persons habitually concluding contracts or habitually negotiating the material elements of contracts that are in the name of the enterprise or that are to be performed by the enterprise can lead to a PE"*. The meaning of "material elements" of contracts and "dependent agent" needs to be more specifically defined in commentary. For the insurance industry, **interpretation of these terms should be clearly linked to the assumption and management of insurance risk** in order to avoid the creation of PEs with non-KERT functions which - following the principles of Part IV - will have no or minimal additional profit attributed to them. Moreover, it would be advisable to clarify that the "material elements" of contracts may vary depending not only on the nature of the contract concerned, but also on the nature of the business concerned and the business model thereof.

An insurance agent or broker (unlike a commissionaire) is acting as a sales function for clients seeking to purchase insurance. The role of insurance agents will vary across the industry and across jurisdictions and an unconnected agent who is performing non-KERT functions and being rewarded commensurate with the duties performed should not be treated as a "dependent agent" even where the agent acts exclusively for a particular business. **Even an agent who accepts insurance risk on behalf of its principal under delegated authority should not create a KERT function where that authority is strictly delineated and limited** (as the agent would not be regulated to assume and manage insurance risk or have the necessary capital that is required by the regulator for that activity). Therefore, insurance agents **should** not create a tax PE of the insurance enterprise.

II. Risk transfer, transfer pricing and cross-border (re)insurance

The insurance industry has concerns as to how the Discussion Draft for **Action Points 8 to 10**, will impact insurers' risk and capital models and reinsurers in particular.

It is the *fundamental characteristic of insurance to take on risks over which insurers themselves have no control, (*e.g. the risk that damage occurs as a result of a wind or winter storm, the risk that the policyholder dies, the risk that the company has to pay damages etc). This is very different from the operational risks the Discussion Draft primarily considers. Insurers must hold capital to support these risks, and this capital is the effective equivalent of plant, machinery and stock in the manufacturing world; absent this capital, insurers cannot operate.

According to the initial discussion draft, moral hazard could impact a third party context to the extent that "the management over the risk is likely to be problematic". Further to the last OECD meeting update of 7 July the OECD secretariat affirmed that there would be new examples in the final paper that will not depend on behaviour or moral hazard - as the latter would be too subjective – but will be linked to more objective rules. The industry welcomes this approach due to the fact that although moral hazard influences certain third party transactions, it does not exist in all transactions; when it does, it impacts the transactions in different ways. In insurance, moral hazard is relevant in the sense that the insured person may in certain situations have incentives to cause a claim, which insurers would have to pay out. Thus, in an insurance context, market premiums charged may not be always the best proxy for moral hazard risk in insurance.

All major insurers of wholesale property and casualty risks and reinsurers operate by insuring global risks (e.g. a pool of risks covering say exposure to US hurricanes, Californian earthquakes, Far East earthquakes and European wind and winter storms), so as to obtain a diversification benefit. **Insurers subsequently manage their risks by diversifying their own portfolios, through reinsurance** (which effectively provides insurance to the insurance company). Such diversification enables insurers to significantly reduce the amount of capital they require globally to support such business.

Insurers typically need to set up separately regulated insurance companies or branches with ring-fenced assets in all the territories they operate. Taken individually, these entities are poorly diversified (the EU is unusual in allowing a single regulator across its members). Consequently, to achieve the best diversification benefit and optimal capital structure, insurers use intra-group reinsurance to transfer a significant proportion of the risks written in local entities to a single intra-group reinsurance carrier that pools those risks. This carrier may also be one of the major underwriting vehicles in the group of third party risk. These intra-group reinsurance transactions are actively reviewed by regulators, who do not tolerate failure to implement contractual terms. Intra-group reinsurance also facilitates and reduces the cost of purchasing reinsurance from third parties, whereby certain risks or risk tolerances are transferred via the reinsurance mechanism.

Therefore, the consideration in the discussion draft that parties should be "allocated a greater share of those risks over which they have relatively more control" is not consistent with the rationale of insurance risk and is better aimed at the more controllable risks of non-insurers. Instead, **insurance risks should be allocated to the parties at risk of unanticipated losses or unanticipated profits**, provided they are able to accept and manage the risk. Regulators, rating agencies and clients' requirements already ensure sufficient capital is held to cover those risks. Hence, **insurance and reinsurance transactions between associated enterprises should be recognised** (and should be priced on an arm's length basis).

In general, cross-border transfers of risk through (re)insurance should not be impacted by this BEPS Action, as the **transfers do not imply artificially or inappropriately shifted profits**. Should the above operating model be disturbed by the BEPS or EU initiatives on corporate taxation, this will result in an undue increase of insurers' cost of capital.

Finally, the discussion draft refers to minimal functional entities. Insurance companies in certain jurisdictions may have few or no staff or equipment and depend on intra-group service companies to provide those functions. This structure is driven by regulatory barriers that prevent insurance companies performing any function other than insurance, including provision of intra-group services to affiliates. The number of staff

involved in designing, accepting and managing the intra-group reinsurance may be relatively limited but of crucial importance. Furthermore, certain routine functions may be supplied from developing countries, so bringing those back to richer locations is not desirable. These operating models do not generate BEPS and need to be respected for tax purposes.

With related work on **Action 3**, the OECD aims to develop controlled foreign company (CFC) rules which are effective in dealing with BEPS issues. Although the insurance industry supports the aim of developing such rules and recommendations, it also believes believe that CFC rules are difficult to consider in isolation from other BEPS actions.

In particular, when dealing with concerns regarding reinsurance activities, the industry would suggest that the BEPS activities targeted could be more appropriately addressed through the OECD BEPS Action which directly impact risk and capital, such as 2, 4, 8, 9 and 10.

The insurance supply chain and value drivers as outlined in Part IV should be taken into consideration in any determination of whether an insurance company has the necessary substance in a territory to undertake business. Insurers use both internal and external reinsurance and retrocession in the process of managing the risks they assume, generating important benefits via diversification and pooling, flexibility in global risk management and capital efficiency. Intra-group reinsurance should therefore continue to be subject to the OECD transfer pricing rules and the arm's-length principle.

In addition to the above considerations, it must be noted that insurers which are regulated in the European Union are allowed to write cross-border business under the **EU Freedom of Services**, *including when income-generating policies cover risks in another EU member state*.

The industry is strongly of the view that income arising from risk assumption in a different territory to the location of the risk is not an automatic indicator of BEPS activity. This is merely a consequence of insurers managing risks on a global basis, including through reinsurance. CFC rules should not restrict the commercial operations of insurers and arrangements which are demonstrably required to optimise capital efficiency and to reinsure third-party risks. The insurance industry therefore welcomes the recent announcement by the OECD that CFC proposals will be considered a best practice standard and will not be mandatory.

III. Capital and interest deductions

With the discussion draft on **Action 4**, the OECD seeks to address BEPS practices using interest and economically equivalent payments.

As explained in the introduction, any discussion about capital in insurance should take into account the fact 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.

The industry welcomes the acknowledgement in the discussion draft that *a different approach is required for the financial sector* in light of these 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.

The OECD acknowledges that for the insurance sector existing regulatory requirements **act already as an interest limitation rule** (i.e. rule which puts an overall limit on the level of debt and hence interest deductions that an entity can claim). The industry agrees with this statement and therefore argues as a **first best solution** that the interest paid as part of insurers' ordinary capital structures and business operations should be excluded from any further 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 that these are addressed by specific targeted rules*.

Territories should be allowed the flexibility to use and adapt existing rules with a proven track record - including arm's length rules. Given that most insurance groups are net interest recipients, a fixed ratio approach may be appropriate for the sector, as long as it 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.

The industry also pointed out 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*. On the other hand, 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. Such debt only qualifies as regulatory capital if the repayment date is long-dated or perpetual (i.e. the capital is of long duration). Hence, it is only reasonable that any current issuances are grandfathered and protected from any new interest rules restricting deductions. It is understood that the Action 4 paper will reach no conclusions on interest restrictions for insurers and will recommend follow up work.

Action 2 of the BEPS Action Plan seeks to neutralise the effects of hybrid mismatch arrangements, based on the OECD's concern that some hybrid instruments can lead to base erosion. While the industry recognises this is a valid concern, it also believes that the proposed OECD rules on hybrid instruments should have no negative **impact on the hybrid regulatory capital of insurers**.

This type of capital is not designed to create tax mismatches and **its use does not constitute a harmful tax practice**. Any rules placing an additional tax burden on these instruments would *increase the cost of raising capital and thus adversely impact the competitiveness of the insurance sector.*

Hybrid instruments are essential to the insurance industry for regulatory and commercial reasons, given that 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.

Insurers reap the following benefits when issuing hybrid instruments:

- hybrid instruments allow insurers to raise capital in a cost-effective way as debt carries less risk for the investor and, as a result, provides a cheaper form of capital than equity;
- hybrid instruments enable an insurer to raise "risk" capital without having to issue equity and thereby diluting existing shareholders;
- 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.

Moreover, regulatory capital ("hybrid") instruments used by insurers are typically placed in the market in form of bonds. With respect to the issuance process, the bonds are usually sold to international investors in a book building process via banks, which buy the bonds from the issuer and immediately sell them to investors. In principle, there is therefore no direct contact between the issuing insurance company and the investors. Even on the day of pricing of a new transaction, the issuing insurance company has only limited information on the identity of the bond investors. Finally, also during the payment process (coupons & principal) there is no direct contact between issuer and holder because the former typically employs paying agents (banks) to make payments.

For these reasons, **the industry 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 any hybrid financial instrument rule, as these types of capital are issued for non-tax purposes and *cannot be regarded as tax abusive*.

The OECD's recognition that the hybrid financial instrument rule should only apply to a financial instrument entered into with a related person or where the payment is made under a structured arrangement and the taxpayer is party to that structured arrangement is therefore explicitly welcome as it preserves insurers' ability to use these capital instruments as explained above.

As the OECD states in its report of September 2014, it intendeds to clarify the application of the rules to hybrid regulatory capital issued intra-group, in order to decide whether a special treatment under the hybrid mismatch rules is justified. In the light of the above mentioned arguments, the industry strongly recommends that the scope of anti-hybrid rules shouldn't be further expanded to include this type of instrument.

IV. Transfer Pricing documentation (TPD) and Country-by-country reporting (CbCR)

The insurance industry fundamentally supports the objective of **Action 13** of the BEPS Action Plan to enhance transparency towards tax authorities, in order to enable tax authorities to get a better view of multinational groups as a whole. However, it is important to note that in this context, the avoidance of additional and excessive bureaucracy, streamlining of reporting requirements and the protection of commercially sensitive information have to be seen as equally important goals.

In particular and with regards to the additional administrative burden, the recommendations of the report published in September 2014 will create substantial burdens for business, as several requested pieces of information are not readily available in the current reporting system and therefore new reporting mechanisms will have to be implemented. Effective compliance will also require significant preparation. Concerning the definition of the data to be reported, the recently published "Country-by-Country Reporting Implementation Package" is only referring to the report from September 2014.

As the deadline for compliance with the OECD's proposals is quickly approaching and the national laws for implementation have to be enacted until the end of this year, it is necessary to provide companies with all the necessary information. Without such guidance, much of the preparation required in view of implementation will be difficult, if not impossible.

Finally and as indicated above, insurance business models are unique and this needs to be recognised when the information on the CbCR template is considered.