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OECD Draft Report on the Attribution of Profits to Permanent Establishments – Part IV

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On August 22, the OECD issued a revised public discussion draft of its Report on the Attribution of Profits to Permanent Establishments Part IV (Insurance), the last part of the Report.

<http://www.oecd.org/dataoecd/46/6/39163765.pdf>

The revised version is the result of consultation following the initial draft, which was released in June 2005, as well as consultation on Part I (General Considerations), Part II (Banking) and Part III (Global Trading), which were finalised in December 2006.

Key changes between the first and second draft of Part IV include:

- Clear differentiation between insurance risks, functions and assets and non-insurance risks, functions and assets, resolving much of the lack of clarity arising from the first draft:
 - Clarification of Key Entrepreneurial Risk Taking functions (KERTs) as undertaking the acceptance and management of insurance risks, being the key determinant of the supporting reserves and capital (surplus);
 - Clarification of Significant People Functions (SPFs) as undertaking the acceptance and management of other (non-insurance) risks as well as undertaking valuable activities in relation to non-insurance assets;
- Identification of two approaches in determining the investment yield from investment assets attributed to a permanent establishment (PE) (top down and bottom up);
- Expansion and refinement of insurance industry description; and
- Removal of the section in the previous draft regarding reinsurance between group companies, which had attracted some negative comments from the industry.

Areas which remain the same in principle, albeit with refined analysis following input from industry, include:

- Allocation of surpluses and investment income to the location(s) where the relevant KERTs reside;

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- Clear indication that head office services should be priced as “arm’s length” services with the associated arm’s length profit margin; and
- The need for arm’s length pricing justification and documentation for all intra-entity transactions.

Areas which remain the same in spite of strong objections from industry include:

- The quasi-thin capitalisation approach to capital attribution has not been raised from a safe harbour to an approved approach;
- The presumption remains that the credit rating of a PE will be the same as the entity as a whole, absent specific local trustee assets. This is in spite of industry arguments around the approaches taken by credit ratings agencies in determining PE ratings.

This bulletin sets out a summary of the revised draft insurance paper and looks to identify some of the key implications for the insurance sector, as well as what insurance groups should be thinking and doing in response to this paper.

The deadline for comments on the draft paper is 31 October 2007 with an expected consultation meeting on 26 November 2007.

Background

The purpose of the OECD Report is to promote international consensus and consistency in the taxation of PEs. The OECD’s Committee on Fiscal Affairs, which has responsibility for this project, brings together senior officials from all OECD member governments, who play an active role in formulating and implementing tax policies.

The OECD’s approach is based on the premise that it is necessary to determine the profits that 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.

This approach has been tested and refined through a process of issuing various drafts of Parts I–IV of the Report, as well as consultations with industry.

Content of revised Part IV

The first 23 pages of the paper set out, in broad terms, the way in which insurance businesses operate. The OECD has clearly listened to business during the consultation process and has incorporated many of the suggestions put forward to refine and improve this section. In particular, there is more substantive discussion on reinsurance, as well as the inclusion of asset/liability management.

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The paper then goes on to explore how, by analysing the functions and assets and risks of a particular line of business, it should be possible to identify the KERTs within that business line.

KERTs are generally those “which require active decision making with regard to the assumption and/or management (subsequent to transfer) of the individual risks and portfolios of risks that have been identified as the most important...”.¹

Interestingly, the OECD has changed the KERT definition from “day to day” decision making to “active” decision making in response to a number of comments from the insurance industry that, following the initial acceptance of a risk, the ongoing management of risk, whilst active, will not typically be on a daily basis. This is a constructive amendment which allows insurers more freedom to apply a facts and circumstances approach to the identification of KERTs after the initial acceptance of the risk.

Generally, however, it is assumed that the underwriting function will, in the first instance, meet the definition of the key entrepreneurial risk taking function.

The OECD considers that it is the key entrepreneurial risk taking functions that will determine the location of the insurance risk and the associated premiums, reserves and surplus, as well as the investment income derived from the investment assets supporting these insurance risks.

However, the OECD is very clear that, whilst the identification of KERTs will determine the initial attribution of insurance risks and assets, other valuable activities and/or assets must also be considered:

“...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.”²

Consistent with Parts II and III, Part IV is very clear that determining the amount of risks to write, without further involvement in assuming or managing the risk, would not generally be considered to be a KERT activity without sufficiently active decision making as to the acceptance of risks.³ The rest of the revised Part IV looks at the application of the authorised OECD approach to an insurance business.

¹ Paragraph 68 Part IV

² Paragraph 73 Part IV

³ Paragraph 70 Part IV

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Application of the authorised OECD approach

The basic premise of the approach is unchanged but has been refined based on the revised Parts I-III and on insurance industry consultation.

The basic approach comprises two steps:

Step 1: A functional and factual analysis, resulting in:

- Attribution of PE's rights and obligations;
- Identification of KERT functions (assuming/managing insurance risk);
- Identification and attribution of investment assets supporting the insurance risk;
- Identification of Significant People Functions (SPFs) relevant to the assumptions of other risks;
- Identification of SPFs relevant to other assets;
- Other functions; and
- Other dealings.

Step 2: The pricing on an arm's length basis of recognised dealings:

Having hypothesised a PE as a distinct and separate entity, the OECD transfer pricing guidelines are then applied by analogy.

The discussions on internal reinsurance have been significantly truncated and clearly reflect the OECD's reluctance to accept internal reinsurance, whilst recognising that, to be consistent with the Parts of the Report relating to banking, genuine risk transfer must be respected.

The revised Draft effectively assumes, as a starting point, that internal reinsurance will not be respected unless the key entrepreneurial risk taking function has clearly transferred from the PE location in relation to ongoing active management of the accepted risks. Otherwise the default position will be to recognise a risk management service (rather than reinsurance) with appropriate arm's length pricing for such risk advisory services.

Practical implications

A large number of points arise from this document, some of the more important issues are:

The activity-based approach

The OECD Draft sets out in even clearer terms that it is the location of the "people" functions, primarily relating to the underwriting activity, that are the core functions which determine the location of the profits of the enterprise. This is on the basis that it is these activities which involve the assumption and management of risk and it is primarily this that gives rise to profits (or losses).

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Surplus (or capital) is required to support the insurance risks assumed by an enterprise and, in the case of a PE, is attributed by reference to the location where risks are assumed and managed, rather than the other way round.

Ownership of investment income

The Draft states that a financial asset should be treated as belonging to the location where the key entrepreneurial risk taking functions have been performed, and, as a result, where the reserves and surplus (or capital) are allocated. This potentially results in very different allocations of investment income in comparison to current practice.

The Draft confirms its previous approaches to the attribution of surplus as:

- The surplus of the whole enterprise is allocated to various parts of the business in proportion to the insurance risks undertaken by each part of the business (the capital allocation approach); or
- Surplus is allocated to an insurance PE by reference to what an independent insurance enterprise carrying on the same or similar activities would have (the thin capitalisation approach).

The quasi thin capitalisation approach, which allocates on the basis of the minimum amount of surplus which would be required for regulatory purposes as an independent enterprise, remains only as a potential domestic law safe harbour, in spite of industry requests to raise this to the level of an authorised approach.

Where the PE location has attributed capital based on one of the authorised approaches, there is a presumption that this should be acceptable in the head office location, even if domestic legislation prescribes a different approach. However, there remains no international consensus amongst governments on this issue and the possibility that companies may need to use the Mutual Agreement Procedure (MAP) remains.

The OECD recognises that it is also necessary to determine what investment yield should be attributed to the assets. The Draft includes two possible approaches to the determination of investment yield on investment assets attributed to a PE.

The top down approach to determining investment yield looks to the return on all uncommitted assets held by the company (or on the company's total assets if that is not possible). To the extent that a PE is attributed investment assets over and above those actually held by the PE (which are assumed to have an identifiable return), the company's overall return may be applied.

The bottom up approach assumes that the rate of return earned on assets held locally are also earned by the additional assets notionally attributed to the PE.

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Application to subsidiaries

The previous Draft contained a section specifically addressing reinsurance between affiliates, which had a strong anti avoidance flavour. Many responses during the consultation process argued that this section was entirely inappropriate in a Report which sought to address PE profit attribution. This section has now been removed, although it is clear from experience that tax authorities are already applying many of the principles established during this project, such as the KERT concept, when undertaking enquiries into inter-company reinsurance.

Dependent agent PE

The Draft does not itself address in detail whether or not a company operating in one country may create a PE of a foreign company in that country. However the draft clearly envisages that such a situation could arise and that as a result a host country would have taxing rights over both the local company (dependent agent) and the foreign company's PE.

The paper goes as far as stating that when attributing profits to the foreign company PE, there are likely to be profits (or losses) over and above the arm's length service fee paid to the dependent agent company as a result of the attribution of investment assets and associated investment income. This is consistent with the position taken in the original draft, although there is at least the recognition that the existence of further taxable profit in the foreign company's PE is not a foregone conclusion and will depend on the specific facts and circumstances of the dependent agent.

Implementation of the OECD Report

Once finalised, the conclusions of Parts I-IV of the Report will be implemented in two stages. The Commentary to Article 7 (Business Profits) of the existing OECD model tax treaty is being revised to incorporate the concepts of the PE Report, but only to the extent that the concepts do not clash with the current wording of the treaty or commentary. A first consultation draft of this revised commentary was released in April 2007, see:

<http://www.oecd.org/dataoecd/0/2/38361711.pdf>

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. This is expected to be released for consultation by the end of 2007.

The OECD states that this two stage approach aims to give maximum legal certainty in the interpretation of both the existing and future treaties. However, it remains to be seen how tax authorities will actively seek to apply the Report's conclusions to tax treaties already in existence given only a partial incorporation of the Report to the existing commentary.

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Next steps

Insurance groups are strongly advised to familiarise themselves with this paper and to play an active role in continuing to shape the evolution of the OECD's thinking.

The OECD has clearly paid heed to many of the points raised during the consultation period and this Draft contains significant and mostly positive changes. PricewaterhouseCoopers would encourage insurance companies to participate in the further consultation and would be happy to help companies in making representations. The deadline for responses is 31 October 2007, with an expected consultation meeting with interested parties on 26 November 2007.

Whilst the Draft is of direct relevance to insurers operating through branches and dependent agents, the principles set out in the Draft, such as the KERT analysis, are already being used by tax authorities as part of the wider consideration of transfer pricing within insurance groups.

It is clear from the evolution of the Report that many taxpayers will need to undertake a full functional analysis of their operations in order to be in a position to assess the extent to which the OECD authorised approach to PE profit attribution may result in potential risks and/or opportunities in respect of:

- Attribution of investment income;
- Head office / branch dealings;
- Intra entity reinsurance;
- Dependent agent permanent establishments; and
- Wider application to intercompany transfer pricing.

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