Insurance Tax Webcast

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

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Welcome

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Before We Get Started

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

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Polling question

The issue that I am most concerned with these days is:

a. Transfer pricing
b. Potential dependant agent permanent establishment assertions
c. Neal bill
d. Cascading excise tax

Agenda

I. Introduction
  - Recent Trend in Financial Services Transfer Pricing
  - Overview of Regulatory Framework

II. Definition of a PE
  - US Trade or Business Consideration
  - US-Bermuda Treaty
  - OECD Article 5

III. OECD Report Part IV
  - Arm’s Length Principle
  - Authorized OECD Approach for Insurance
  - Important points & Potential impacts

I. Introduction

- Recent Trend in Financial Services Transfer Pricing
- Regulatory Frameworks and OECD Report

I. Introduction
Background of OECD Report

OECD Model Treaty Art. 7 (Arm's Length Principle)

OECD Model Treaty Art. 7 Commentary

OECD Reports/ Papers (for Art. 7)
（Report on Attribution of Profits to PEs）

OECD Transfer Pricing Guidelines (for Art. 9)

Draft

2008 Update

Note:
1. OECD Guidelines and Papers are applicable where there is a tax treaty under the OECD Model Treaty. If not, we need to consider domestic rules.
2. Most of OECD Report has been already included in the 2008 Update of Model Tax Convention, released in July 2008.
3. A Discussion Draft on New Article 7 (Business Profits) was released in July 2008. Open for comments until December 31, 2008.

I. Introduction
Overview of Transfer Pricing Regulatory Framework

OECD

- Model Treaty **Article 7 (for PE)** and **9 (for affiliates)**
- OECD Transfer Pricing Guidelines
- OECD Papers for Attribution of Profits to PE
  - Part I General Considerations;
  - Part II Banks;
  - Part III Global Trading; and
  - Part IV **Insurance**.
- On-going Projects:
  Business Restructuring; and
  Comparability and Profits Method

US

- Internal Revenue Code Section 482
- Treasury Regulations Section 1.482
- Temporary Services Regulations
- Proposed Global Dealing Regulations

Other Countries

Polling question

The OECD Report on Attribution of Profits to PEs is relevant to me primarily because:

a. We operate through branches in certain jurisdictions.
b. We are concerned that we may face potential dependant agent permanent establishment assertions by tax authorities
c. We are in transfer pricing disputes with tax authorities
d. The OECD Report may be used for transfer pricing purposes by tax authorities.

Polling question

The most relevant definition of PE to me is:

a. Definition of PE under the US domestic rules regarding US trade or business
b. Definition of PE under OECD Model Treaty Article 5
c. Definition of PE under Treaties with Bermuda

II. Definition of PE

General US Nexus Principles (“US Trade or Business” or “USTB”)

Direct USTB Considerations

- “USTB” not defined in code/regulations, but Section 864(b) provides that performance of services in the United States a USTB, excluding certain temporary personal services and trading in stocks and securities (US Trading/Investing Safe Harbor).
- USTB determination is a highly fact sensitive analysis. See Treas. Reg. §1.864-2(e). Principles culled from case law:
  - “Considerable, continuous & regular” activity.
  - “Active” Activity.
  - Taking place in US.

II. Definition of PE

General US Nexus Principles ("US Trade or Business" or "USTB")

Indirect USTB Considerations

- General Proposition: activities of US subsidiary do not cause a PE for foreign parent company. See Treas. Reg. §1.864-3(b)(ex.).
- Independent Agent – subsidiary activities are generally not imputed to the foreign principal to treat the foreign principal as engaged in a USTB.
- Dependant Agent – subsidiary activities can be imputed to the foreign principal and may result in treating the foreign principal as engaged in a USTB. See, e.g., Inverworld Inc. v. Comm'r, 71 T.C.M. (CCH) 3231 (1996).
  - Consider protective filings to avoid loss of deductions under Section 882(c). See SWALLOWS HOLDING, LTD. v. Comm'r 515 F.3d 162 (3rd Cir 1998).
- Section 894 provides generally that the above principles shall be applied with due regard to US treaty obligations
  - Special rules under Section 894(c) for denial of treaty benefits through hybrid entities.

II. Definition of PE
1986 US-Bermuda Tax Convention – Article 3 (PE)

- A permanent establishment is created when there is a sales outlet or **place of management;**
- The furnishing of **consultancy, technical, managerial services** will also create a permanent establishment if these activities are performed for more than 90 days in a 12 month period or if these services are performed for an "associated enterprise."
- A permanent establishment can be created through an agent:
  - Independent Agent—An agent acting in the ordinary course of their business (broker, general commission agent) will not create a PE. If the agent's activities are devoted substantially to those if one business, the agent will not be independent if the transactions are not made at arm's length.
  - Dependent Agent—An agent can create a permanent If the agent has and habitually exercises the authority to conclude contracts on behalf of a business.
- A jurisdiction can only tax income that is attributable to a PE within that jurisdiction.

II. Definition of PE
2005 OECD Model Tax Convention – Article 5 (PE)

Direct Permanent Establishment (PE) Considerations

1. For the purposes of this Convention, the term "permanent establishment" means a fixed place of business through which the business of an enterprise is wholly or partly carried on.
2. The term "permanent establishment" includes especially: (a) **a place of management**, (b) a **branch**, (c) an **office**, (d) a factory, (e) workshop, and (f) a mine, an oil or gas well, a quarry or any other place of extraction of natural resources.
3. A building site or construction or installation project constitutes a permanent establishment only if it lasts more than twelve months.

II. Definition of PE
2005 OECD Model Tax Convention – Article 5 (PE)

Direct Permanent Establishment (PE) Considerations, continued

4. Notwithstanding the preceding provisions of this Article, the term "permanent establishment" shall be deemed not to include:
   a) the use of facilities solely for the purpose of storage, display or delivery of goods or merchandise belonging to the enterprise;
   b) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage, display or delivery;
   c) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise;
   d) the maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise or **of <u>collecting information</u>, for the enterprise;**
   e) the maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any other activity of a <u>preparatory or auxiliary character</u>;
   f) the maintenance of a fixed place of business solely for any combination of activities mentioned in sub-paragraphs a) to e), provided that the overall activity of the fixed place of business resulting from this combination is of a preparatory or auxiliary character.

II. Definition of PE
2005 OECD Model Tax Convention – Article 5 (PE)

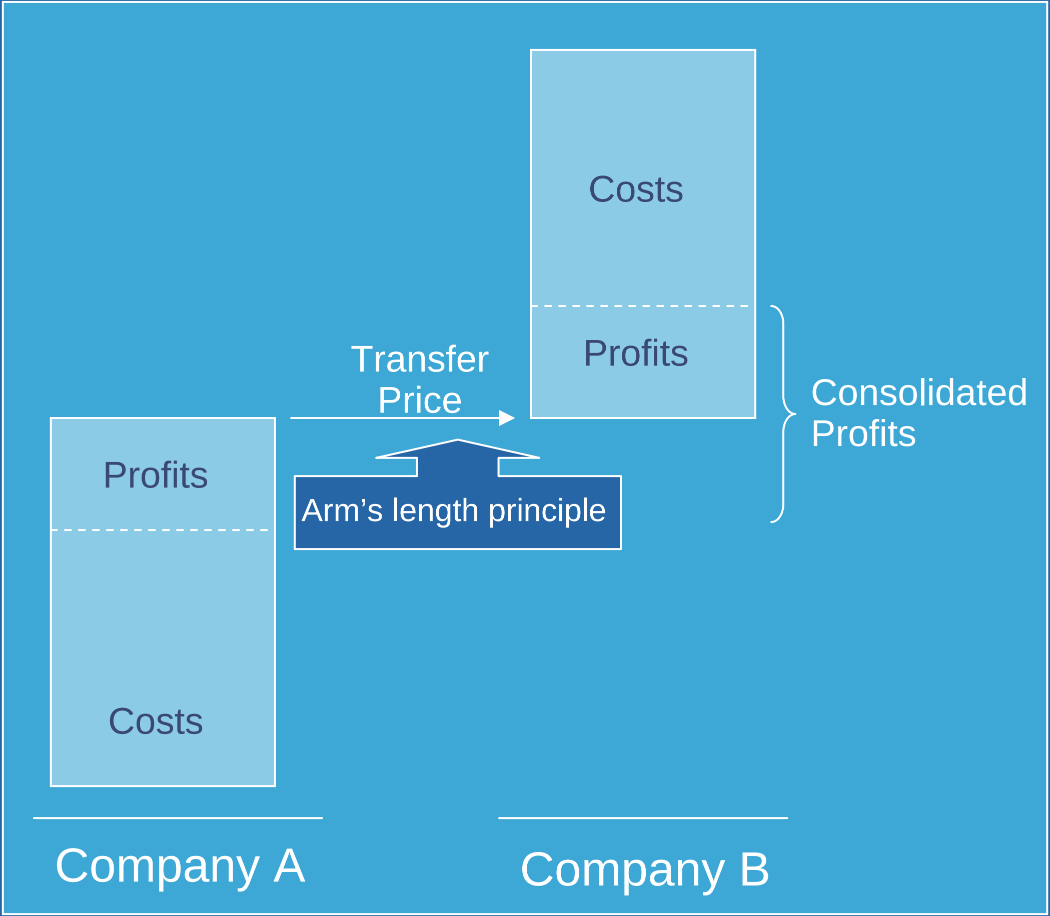
Indirect Permanent Establishment (PE) Considerations

5. **Notwithstanding the provisions of paragraphs 1 and 2, where a person --other than an agent of an independent status to whom paragraph 6 applies --is acting on behalf of an enterprise and has, and habitually exercises, in a Contracting State an authority to conclude contracts in the name of the enterprise, that enterprise shall be deemed to have a permanent establishment in that State in respect of any activities which that person undertakes for the enterprise, unless the activities of such person are limited to those mentioned in paragraph 4 which, if exercised through a fixed place of business, would not make this fixed place of business a permanent establishment under the provisions of that paragraph.**
6. **An enterprise shall not be deemed to have a permanent establishment in a Contracting State merely because it carries on business in that State through a broker, general commission agent or any other agent of an independent status, provided that such persons are acting in the ordinary course of their business.**
7. The fact that a company which is a resident of a Contracting State controls or is controlled by a company which is a resident of the other Contracting State, or which carries on business in that other State (whether through a permanent establishment or otherwise), shall not of itself constitute either company a permanent establishment of the other.

II. Definition of PE
Permanent Establishment under New OECD Tax Treaty

- Discussion on Changes to Article 5
- In light of Changes to Articles 7 and 9

III. OECD Report Part IV Arm's Length Principle



Key Elements

- Arm's Length Standard
- Separate Entity Hypothesis
- Economic Characterization
- Selection of Transfer Pricing Methods
- Application of Transfer Pricing Methods

III. OECD's Report on Attribution of Profits to PEs – Part IV Authorized OECD Approach ("AOA") for Insurance

"**Authorized OECD Approach**" ("AOA") = "**Functionally Separate Entity**" Approach.

- Profits to be attributed to a PE are the profits that the PE would have earned at arm's length if it were a legally distinct and separate enterprise performing the same/similar functions under the same/similar conditions dealing wholly independently with the enterprise of which it is a PE.

Key Entrepreneurial Risk-taking ("KERT") Functions

- **Definition.** Functions requiring active decision-making for the acceptance and/or management (and subsequent to the transfer) of individual and portfolios of risks.
- **Why important?** It is the performance of KERT functions that leads to the assumption of the greatest risks and the authorized OECD approach attributes economic ownership of the income-generating assets.

Under Part IV Insurance,

KERT = Assumption of Insurance Risk

Step I. Functional and factual analysis to determine…

Identification of the location of the **Key Entrepreneurial Risk-Taking ("KERT") Functions: i.e., the Assumption of Insurance Risk**

↓

Attribution of Insurance Risk (therefore Surplus and Reserves relating to that risk)

↓

Attribution of **Investment Assets**, to the extent necessary to meet the reserves and surplus needs created by the attributed insurance risk

↓

Step II. Arm's Length Pricing based on the Characterization of the PE

Polling question

Which of the following countries are you concerned most for transfer pricing:

a. US
b. UK
c. Canada
d. Australia
e. Japan

III. OECD's Report on Attribution of Profits to PEs – Part IV Important Points and Potential Impacts

- **Associated enterprises.** Part IV does not discuss applications for transactions among associated enterprises (e.g., subsidiary and parent).
- **Importance as guidance.** Part IV is the only insurance industry-specific guidance issued on transfer pricing, both for taxpayers and for tax authorities.
- **KERT function.** Part IV defines KERT function as the function assuming the insurance risk.
- **Dependent agent PE.** If a PE is deemed to exist, Part IV provides methodologies to quantify the profit that should be attributed to the PE.
- **Non-treaty countries.** Part IV may contradict domestic rules of non-treaty countries.
- **Regulatory.** A possibility of divergence between regulatory and tax leading to accounting versus tax book differences and increased administrative burden.
- **Internal reinsurance dealing.** It is respected only when supported by performance of actual KERT functions – heavy reliance on the facts surrounding a transaction.

III. OECD's Report on Attribution of Profits to PEs – Part IV Important Points and Potential Impacts

- **Use of profit split.** Potentially, a more frequent use of profit split than before.
- **Pre-AOA versus post-AOA.** Focus on the reward for services under the Part IV (post-AOA) vs. traditional allocation of branch or head office expenses (pre-AOA).
- **Part II and III.** For insurance companies' activities other than insurance, Part II and III may be applicable, and similarly, Part IV may apply to companies who have a insurance business segment.
- **Documentation.** Documentation is important in absence of contracts, and is likely to be scrutinized.
- **Functional and factual analysis.** Clear from Part IV that a comprehensive functional and factual analysis must be undertaken and documented. These facts will be the backbone of any analysis.
- **Uncertainty.** For some areas, there is no uniform consensus or clarity in Part IV. (e.g., attribution of investment assets, determination of investment yield, allocation of external reinsurance costs).

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

Questions?

EXHIBITS

EXHIBIT A: OECD's Report on Attribution of Profits to PEs Authorized OECD Approach ("AOA") – General

Part I. General Considerations.

"**Authorized OECD Approach**" ("AOA") = "**Functionally Separate Entity**" Approach.

- "Profits to be attributed to a PE are the profits that the PE would have earned at arm's length if it were a legally distinct and separate enterprise performing the same or similar functions under the same or similar conditions and dealing wholly independently with the enterprise of which it is a PE."
- "The authorised OECD approach attributes to the PE those risks for which the significant functions relevant to the assumption and/or management (subsequent to the transfer) of risks are performed by people in the PE and also attributes to the PE economic ownership of assets for which the significant functions relevant to the economic ownership of assets are performed by people in the PE."
- The authorised OECD approach attribute capital, including "free" capital to the PE to support the functions it has performed, the risks assumed and assets attributed to it.

<u>Step I.</u> Functional and factual analysis to determine…

Identification of **Significant People Functions** relating to assumption of risk	Identification of **Significant People Functions** relating to economic ownership of assets
↓	↓
Attribution of risk	Attribution of asset

+

Attribution of capital to support the identified "functions, attributed "risk" and "assets"

↓

<u>Step II.</u> Arm's Length Pricing based on the Characterization of the PE

EXHIBIT B: OECD's Report on Attribution of Profits to PEs Authorized OECD Approach ("AOA") – Financial Services

Key Entrepreneurial Risk-taking ("KERT").

Functions are:

Functions requiring active decision-making for the acceptance and/or management (and subsequent to the transfer) of individual risks and portfolios of risks.

Bank (Part II) => KERT = The creation of a financial asset and its subsequent management.

Global Trading* (Part III) => KERT = Market risk management function.

Insurance (Part IV) => KERT = **The assumption of insurance risk.**

* The term "global trading" refers primarily to those entities that engage in market making on a global or 24-hour basis, but may also refer to the dealing or brokering of financial instruments in customer transactions where some part of the business takes place in more than one jurisdiction.

Step I. Functional and factual analysis to determine…

Identification of **Key Entrepreneurial Risk-Taking ("KERT") Functions**

↓

Attribution of financial assets and related risks risk

+

Attribution of capital to support the identified "functions, attributed "risk" and "assets"

↓

Step II. Arm's Length Pricing based on the Characterization of the PE

EXHIBIT C: OECD’s Report on Attribution of Profits to PEs
Step I. Functional Analysis
Assumption of Insurance Risk = KERT

- The most important active decision-making functions relevant to the assumption of insurance risk =Typically Underwriting Activities (but maybe other functions (e.g. product development, sales and marketing, and risk management)).
- Underwriting Activities may include:
  - Setting the underwriting policy.
  - Risk classification and selection.
  - Pricing.
  - Risk retention analysis.
  - Acceptance of insured risk.
- Parameter-setting, without further involvement in assuming or managing the risk would not be KERT.
  - e.g., Sr management’s setting of overall strategic parameters which are changed infrequently with little further ongoing active involvement in the decision making relating to the assumption of risk would not be a KERT function.
  - e.g., Sr management’s setting of overall strategic parameters which is more kin the nature of ongoing operational than purely strategic parameter-setting (i.e., involving sufficiently active decision-making as to the acceptance of particular insured risks) may be a KERT function.
- Regulatory position (e.g., a license to conduct insurance business) may be a start point, but would not be followed if inconsistent with the location of KERT functions.
- It is possible for more than one location performing KERT functions.

EXHIBIT D: OECD’s Report on Attribution of Profits to PEs
Step I. Functional Analysis
Allocation of Investment Assets to a PE

- There are two authorized approaches:
  - Capital allocation approach.
  - Thin capitalization/adjusted regulatory minimum approach.
  - (Plus quasi-thin capitalization/ regulatory minimum approach only as a domestic safe harbour).
- No one consensus => Potential source of disagreements.
- Investment assets required to cover its reserves and the minimum regulatory surplus may not produce arm’s length results, as it is not reflective of insurance companies’ financial strength.
- Capital allocation approach:
  - Start point is the actual investment assets held by the entity.
  - Possible allocation keys: reserves, premiums, other regulatory measures (solvency margins, minimum regulatory asset requirements), etc.
- Thin capitalization/ adjusted regulatory minimum approach:
  - Attribution is by reference to the amount of investment assets of an independent insurance enterprise carrying on the same or similar activities and assuming the same or similar risks under the same or similar conditions.
- Safe harbour – Quasi thin capitalisation/ regulatory minimum approach:
  - Not AOA, but possibly acceptable as a domestic safe harbour in a host country as long as it attributes assets not more than the amount under AOA.

EXHIBIT D: OECD's Report on Attribution of Profits to PEs
Step I. Functional Analysis
Allocation of Investment Assets to a PE

- Investment Yield
  - Top-down approach. Use of the rate of return earned on all investment assets held by the company.
  - Bottom-up approach. Using the rate of return earned on investment assets held in the host country, assuming the attributed assets also yield a similar return.

EXHIBIT E: OECD's Report on Attribution of Profits to PEs
Step II. Arm's Length Compensation

- Underwriting insured risk. The part that performs this function is the "economic owner" of the insurance policy: accordingly entitled for underwriting income and investment income.
- Risk management function of determining external reinsurance including asset and liability management. Potentially a profit split where integrated.
- Asset management. Potentially CUP method using fund managers' compensation. Such costs should be borne by the "economic owner" of the assets.
- Product management/ development. Remuneration for this function needs to be examined under the Guidelines for either intangibles or services.
- Sales and marketing. Comparables may be available for such function. If "structuring" in an integrated manner is involved, potentially profit split.

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