

# Financial Services Tax News

Financial Services Tax Group

Special Issue - July 2005

Tax Practice of PricewaterhouseCoopers Japan (Zeirishi-Hojin ChuoAoyama) is the largest professional tax corporation in Japan with more than 300 professionals. Our Financial Services Tax Group is comprised of approximately 70 professionals, dedicated specifically to advising the financial services industry. PricewaterhouseCoopers ([www.pwc.com](http://www.pwc.com)) provides industry-focused assurance, tax and advisory services for public and private clients. More than 120,000 people in 144 countries connect their thinking, experience and solutions to build public trust and enhance value for clients and their stakeholders.

This Tax News is provided for general guidance only, and does not constitute the provision of advice or professional consulting of any kind. Before making any decision or taking any action, you should consult your usual PwC contact with all the pertinent facts relevant to your particular situation.

**PricewaterhouseCoopers  
(Zeirishi-Hojin ChuoAoyama)  
Financial Services**

Kasumigaseki Bldg., 15F  
2-5 Kasumigaseki 3-chome  
Chiyoda-ku, Tokyo 100-6015  
Telephone: 81-3-5251-2400  
<http://www.pwc.com/jp/tax>

\*connectedthinking

© 2005 PricewaterhouseCoopers. All rights reserved. PricewaterhouseCoopers refers to the network of member firms of PricewaterhouseCoopers International Limited, each of which is a separate and independent legal entity. \*connectedthinking is a trademark of PricewaterhouseCoopers LLP.

## Insurance OECD Discussion Draft Report on the Attribution of Profits to a Permanent Establishments – Part IV

On 27 June, the OECD published the long awaited Discussion Draft of the Report on the Attribution of Profits to a Permanent Establishment – Part IV (Insurance) (“Part IV”).

<http://www.oecd.org/dataoecd/43/49/35045710.pdf>

This 56 page document is the final part of the OECD’s Report. The other parts comprise:

Paper I – General Considerations  
Paper II – Banks  
Paper III – Global Trading of Financial Instruments

It is clear that Part IV of the report is heavily influenced by previous work done in relation to Part II – Banks.

The OECD Report proposed a Working Hypothesis that a branch (a permanent establishment, or PE) should be treated as if it were a separate entity dealing at arm’s length with the rest of the entity and with other parties. The proposed approach could significantly affect PE/head office profit attributions and increase taxpayers’ compliance burdens.

Key potential issues arising for the insurance industry include:

- Focus on “key entrepreneurial risk takers” (KERTs) who accept and manage risk within the business;
- Allocation of reserves, surpluses and associated premiums and investment income to the location(s) where the relevant KERTs reside;

- Focus on the methods that may be used to allocate investment income to PEs;
- The need for arm's length pricing justification and documentation for all intra-entity transactions;
- An acceptance that reinsurance between a PE and its Head Office may be acceptable; and
- Inter-company reinsurance should be supported by a functional analysis.

This Newsletter sets out a summary of Part IV 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.

## **Background**

The purpose of the OECD Report is to promote international consensus and consistency in the taxation of permanent establishments. 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.

In initiating this Report, the OECD recognised that:

- There is considerable variation in the domestic laws of OECD Member countries regarding the taxation of insurance PEs; and
- There is no consensus amongst the OECD Member countries as to the correct interpretation of Article 7 of the OECD Model Tax Treaty (Business Profits), which can lead to double taxation, or sometimes less than single taxation.

As a first step in establishing a broad consensus, a Working Hypothesis was developed as to the preferred approach for attributing profits to a PE. This approach is based on the premise that it is necessary to determine the profits which 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. It is worth noting that the OECD explicitly rejected any approach based on apportionment of the overall profits/losses of the entity.

This Working Hypothesis has been tested and refined through a process of issuing various Discussion Drafts of Parts I-III of the Report together with consultation with industry and interested parties. As a result of consultation on, and refinement of the Report, the Working Hypothesis has now become the "Authorised OECD Approach".

Part IV deals with the application of the Authorised OECD Approach to an insurance business.

## **Content of Part IV**

The first 21 pages set out, in broad terms, the way in which insurance businesses operate.

The paper 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 key value drivers (or Key Entrepreneurial

Risk Taking Functions, known as KERTs) within that business line.

Key Entrepreneurial Risk Taking Functions is defined (at paragraph 75) as those “*which require active decision making with regard to the taking on and day-to-day management of the individual risks and portfolios of risks that have been identified as the most important...*”.

The OECD considers that it is these KERTs that are likely to impact most directly on the profitability of the insurance enterprise, owing to the assumption of risks and the requirement for capital.

In general, the OECD expects that, whilst this analysis will depend on the specific facts and circumstances, such functions typically require two key decisions:

- The decisions as to what insured risks to accept and on what terms; and
- Which of those risks to retain and which to reinsure.

The remainder of the paper looks at the application of the Authorised OECD Approach to an insurance business.

## **Application of the Authorised OECD Approach**

### *Step 1: Hypothesise the PE as a separate entity*

This involves a thorough functional and factual analysis to identify the economically significant activities and responsibilities undertaken by the insurance enterprise as a whole, before going on to identify which are undertaken by the PE and to what extent.

Key to this analysis is the OECD’s proposal that surplus (defined as paid in capital plus accumulated profits or losses not paid out by way of dividend) and technical reserves should be allocated where the key entrepreneurial risk taking functions are undertaken. It may follow that this is the same location where the surplus and technical reserves are recognised for regulatory purposes. However, this would not necessarily follow if the regulatory requirements are inconsistent with the actual location of the KERTs. Companies will be expected to have done a factual and functional analysis.

### *Step 2: Determine the profits under the separate entity assumption*

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

Key proposals affecting the insurance industry are:

- Premiums and investment income will be expected to follow the allocation of surplus and technical reserves under Step 1 above; and
- The profit attributed will need to take into account arm’s length pricing to reward other functions performed in respect of the business written.

## Practical implications of Part IV

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

### *The activity-based approach*

Part IV sets out in the clearest terms that it is the location of the “people” functions, primarily relating to risk management, 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 which gives rise to profits (or losses). Much emphasis is placed on the functional analysis required to analyse the location of these “people functions”.

Surplus (or capital) is required to support the 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*

Part IV 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.

Investment income and gains are very important to an insurance company. Part IV concludes that the attribution of investment income is a pivotal step in the process of attributing profits to PEs.

The paper debates at length the advantages of various methods of allocating the surplus (or capital) in an insurance company as a base by which to determine investment income:

- 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*).
- 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*).
- Surplus is allocated on the basis of the minimum amount of surplus which would be required for regulatory purposes as an independent enterprise (*a quasi thin capitalisation approach*).

Part IV notes that the consultation process on Parts I–III has shown there is no single internationally accepted approach for the attribution of capital and that the OECD should therefore limit itself to providing guidance on the principles. A key problem with this approach is the potential for disagreement among tax authorities.

### *Dealings between branch and Head Office*

Part IV accepts that it is possible for reinsurance between a PE and its Head Office will be effective for tax purposes. Consistent with the revised draft of Part II is the increased focus in

the paper on a threshold for recognising “dealings” between a PE and different parts of the same enterprise. This appears to reflect a wider anti-avoidance agenda among tax authorities in relation to risk transfers, with the concern being that PEs will, for example, enter into reinsurance transactions with other parts of the insurance company in order to shift risk and manipulate the taxable profits arising in different jurisdictions. However, if the functional analysis supports a transfer of risk then the internal reinsurance should be recognised for tax purposes. It may be, for example, that the home office purchasing external reinsurance to cover risks written by the PE will be sufficient to show the risk is not managed by the PE.

## **Application to Subsidiaries**

Part IV highlights the importance of inter-company reinsurance for some property and casualty insurers. The report stresses the need for an adequate functional analysis as a cornerstone of any comparability analysis on the arm’s length character of transactions between associated parties. The report does not deal in detail with these issues but highlights this might be explored further in developing and expanding the OECD Transfer Pricing Guidelines.

### *Dependent Agent PE*

The paper 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 paper 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 dependent agent 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 surplus, reserves and associated income, including investment income.

## **Implementation of the OECD Report**

Once finalised, the conclusions of Parts I-IV of the Report will be implemented through revision of the Commentary on Article 7 of the Model Double Tax Treaty, and/or the Article itself. Further practical guidance will be produced in the form of background Reports and/or Chapter(s) of the OECD Transfer Pricing Guidelines. The projected completion date for the project –which entails both refinement and finalisation of the Report itself and revision of the Commentary on Article 7 and/or the language of the Article itself - is no later than January 2007.

## **Next Steps**

Insurance groups are strongly advised to familiarise themselves with this paper and to play an active role in shaping the evolution of the OECD’s thinking. There has already been extensive public consultation with the Banking Industry on Parts II and III, which has continued over a period of years, and which PwC has been heavily involved in.

The initial period for comments ends on 16 September 2005. It is likely that, provided there is sufficient response from the insurance industry, there will be a consultation with industry and interested parties, consistent with the previous papers. We expect the OECD to be heavily

influenced by such comments and consultations, based on comments already made by sources within the OECD.

The OECD has in particular requested comments on:

- The factual accuracy of the analysis of the most important functions of the modern insurance industry.
- The impact of regulation, and in particular host country regulation, on the conduct of insurance business.
- The commercial rationale for internal reinsurance within a single enterprise.
- The use of alternative risk transfer mechanisms, such as catastrophe bonds.
- The various approaches to allocating investment income to a PE.
- Other issues as identified within the body of the Report.

The deadline for comments on the draft of Part IV is 16 September 2005.

If you wish to make comments please send them to Stuart Porter at [stuart.porter@jp.pwc.com](mailto:stuart.porter@jp.pwc.com). PwC will be holding a number of seminars around the world to try to help ensure a robust and informed response is given to the OECD. We will be holding an afternoon briefing seminar at the Tokyo American Club for our Insurance Club members on Wednesday, 7 September, for which we will issue invitations shortly.

**For further information, please contact:**

<b>Partner</b>	Sachihiko Fujimoto	81-3-5251-2423	sachihiko.fujimoto@jp.pwc.com
	Katsuyo Oishi	81-3-5251-2565	katsuyo.oishi@jp.pwc.com
	Yuka Matsuda	81-3-5251-2556	yuka.matsuda@jp.pwc.com
	Tetsuo Imura	81-3-5251-2834	tetsuo.imura@jp.pwc.com
	Akemi Kitou	81-3-5251-2461	akemi.kitou@jp.pwc.com
	Raymond Kahn	81-3-5251-2909	raymond.a.kahn@jp.pwc.com
<b>Managing Director</b>	Stuart Porter	81-3-5251-2944	stuart.porter@jp.pwc.com
<b>Senior Manager</b>	Hiroshi Takagi	81-3-5251-2788	hiroshi.takagi@jp.pwc.com
<b>Manager</b>	Kimihito Takano	81-3-5251-2698	kimihito.takano@jp.pwc.com
	Hiroko Suzuki	81-3-5251-2156	hiroko.suzuki@jp.pwc.com
	Shunji Suzuki	81-3-5251-2483	shunji.suzuki@jp.pwc.com
	Kenji Nakamura	81-3-5251-2589	kenji.nakamura@jp.pwc.com
	Yoko Kawasaki	81-3-5251-2450	yoko.kawasaki@jp.pwc.com
	Keiko Arai	81-3-5251-2771	keiko.arai@jp.pwc.com
	Marc Lim	81-3-5251-2867	lim.marc@jp.pwc.com
	Miyuki Kajiwara	81-3-5251-2520	miyuki.kajiwara@jp.pwc.com
	Nobuyuki Saiki	81-3-5251-2570	nobuyuki.saiki@jp.pwc.com
	Yoji Kiyomiya	81-3-5251-2303	yoji.kiyomiya@jp.pwc.com