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Release of Finalized Part IV (Insurance) of the OECD Report on the Attribution of Profits to Permanent Establishments

On July 18, 2008 the Organization for Economic Cooperation and Development ("OECD") issued a finalized Report on the Attribution of Profits to Permanent Establishments, Part IV (Insurance) ("Part IV").

The final version of Part IV expressly replaces and revokes all previous drafts. It is the result of previous consultation drafts in June 2005 and August 2007 and, together with the finalized versions of Parts I to III (released on December 21, 2006), comprises the full OECD Report on the Attribution of Profits to Permanent Establishments ("PE Report").

This Financial Services Tax News outlines the major changes to Part IV. By way of background, the proposed "authorized OECD approach" for the attribution of profits to a permanent establishment ("PE") is summarized below. (For a more detailed discussion and background to the "authorized OECD approach", please refer to our earlier editions of Financial Services Tax News, dated July 2005, January 2007 and September 2007.) A link to the PE Report is located at: <http://www.oecd.org/dataoecd/20/36/41031455.pdf>

Authorized OECD Approach

The authorized OECD approach hypothesizes that the PE is a separate and distinct enterprise, and then applies the following two-step process:

- (1) Conduct a full functional and factual analysis of the PE in order to:
 - Attribute economic ownership of the financial assets of the enterprise to the entity performing the key entrepreneurial risk-taking (“KERT”) functions [together with risks associated with those functions]; and
 - Allocate non-financial assets and associated risks between the PE and its home office on the basis of significant people functions (“SPF”), rather than KERTs.
- (2) Determine profits of the PE by applying the OECD’s “Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations” to the hypothesized separate and distinct enterprise having the functions and risks determined in Step (1).

Key Changes

Part IV adopts many of the changes and clarifications requested at the OECD consultation meeting held in November 2007. These are:

Risk assumption no longer the only KERT (*Part IV, paras. 34-37; 94*)

The previous versions of Part IV were strongly worded on the presumption that risk assumption was the default KERT activity. However, during the consultation process, strong representations were made that risk management could, in certain circumstances, be a KERT activity and that the definition of underwriting was too narrowly drafted. The definition of underwriting has now been expanded to include “classifying” insurance risks, as well as selecting and insuring risks.

Paragraph 94 has been significantly expanded to address the proposition that a risk management function, which has active decision making involvement in the acceptance of particular insurance risks, would be accepted as a KERT function.

Depending on the particular facts and circumstances of the insurance business under consideration, these changes could have important consequences on the types of people who may be considered to be KERTs.

External reinsurance allocations (*Part IV, paras. 171-173*)

Part IV now contains a new section that considers the potential difficulties in dealing with the allocation of external reinsurance to PEs. In particular, Part IV recognizes the allocation challenges arising from certain types of insurance (such as stop loss), in particular:

- The allocation of premiums;
- The allocation of recoveries; and
- The effect of such reinsurance on the reserves/surplus of a PE.

Rather than prescribing an approach, Part IV encourages both taxpayers and tax authorities to adopt a flexible and pragmatic approach based on the specific facts and circumstances surrounding the reinsurance.

Clarifications

The finalized version of Part IV also includes a number of clarifications, which were requested during the consultation period to encourage consistent interpretation of terms and definitions, and address the boundaries of Part IV's impact. These include:

- Clarification that the description of the insurance industry contained in Part IV is not exhaustive and may be applicable to some kinds of insurance more than others (*para. 5*);
- Revised terminology throughout Part IV, replacing "underwriting risk" with "insurance risk", and "financial assets" with "investment assets";
- Explicit references to the impact of reinsurance premiums/recoveries on an entity's underwriting income and the recognition that not all reinsurance results in ceding commissions (*para. 20*);
- Explicit acknowledgement that the assets used to support insurance risks may not all be income bearing (*para. 51*);
- Explicit recognition that thin capitalization issues may also be relevant to the insurance sector, resulting in potential disallowance of interest payments (*para. 76*);
- Explicit statement that the attribution of investment assets for PE profit attribution purposes does not carry wider implications as regards, e.g., withholding tax (*para. 166*);
- Comments on the interaction with the "effectively connected" aspects of Articles 10(4) and 11(4) of the OECD Model Tax Convention (*paras. 226-227*); and
- More references on the application of Part IV to life insurance issues (*paras. 13, 28, 30-32, 34, 56, 59, 157 & 168*).

Implementation

The commentary to Article 7 of the existing OECD Model Tax Convention has been revised to incorporate the concepts of the PE Report (*Appendix, pp231-260*), but only to the extent that the concepts do not conflict with the current wording of the treaty or commentary. A first consultation draft of this revised commentary was released in April 2007 and the finalized version on July 18, 2008.

New text for Article 7, together with the accompanying commentary, was released in draft form for consultation on July 7, 2008. The consultation period ends in December 2008.

The addendum to the PE Report:

- Recommends the adoption of the PE Report's findings in relation to existing tax treaties (to the extent that it does not conflict with the revised Article 7 commentary) by tax authorities of member states;
- Invites adoption by non-member economies to the extent that tax treaties are based on Article 7 of the OECD Model Tax Convention; and
- Instructs the Council of Fiscal Affairs to continue its work in drafting the new Article 7 and commentary.

A number of tax authorities, such as the UK and Australia, are already adopting the principles contained in the PE Report in their considerations of PE profit attribution. Several countries are also considering incorporating the PE Report into local legislation.

Nonetheless, there are a number of legal impediments to the immediate introduction of the approach set out in the PE Report in many other countries. Many tax authorities, including Japan, have also remained silent on the subject of implementation thus far, resulting in significant local uncertainty.

Next Steps

Insurance groups are strongly advised to familiarize themselves with Part IV and to consider the potential implications, taking into consideration:

- The current approach taken by the group to branch profit attribution; and
- The current position being taken by local tax authorities, as well as the expectation of future developments.

It is clear from the evolution of the PE Report that many taxpayers, including insurance industry taxpayers, will need to undertake a full functional analysis of their operations. This will enable them to assess the extent to which the authorized OECD approach to PE profit attribution may result in potential risks and/or opportunities for their business.

A Japanese translation of the final versions of Parts I, II and III of the PE Report can be downloaded from the website of the Japanese National Tax Agency at the link below:

<http://www.nta.go.jp/sonota/kokusai/oecd/press/10.htm>

For more detailed information, please do not hesitate to your financial tax services representative or any of the following members:

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