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GFIA Comments on OECD Discussion Draft on BEPS Actions 8, 9 and 10: Discussion draft on revisions to Chapter I of the Transfer Pricing Guidelines (including risk recharacterisation, and special measures)

Introduction

The Global Federation of Insurance Associations (GFIA) through its 38 member associations represents insurers that account for around 87% or more than $4 trillion in total insurance premiums worldwide. GFIA is pleased to provide comments on the OECD discussion draft on BEPS Actions 8, 9 and 10: Discussion draft on revisions to Chapter I of the Transfer Pricing Guidelines (including risk recharacterisation, and special measures) (the "discussion draft"). In general, the GFIA supports the objectives of the OECD BEPS Action Plan to address weaknesses in the international tax environment. Accordingly, the GFIA supports the broad objectives of the discussion draft to ensure that the genuine substance of transactions is documented and reflected in a group's transfer pricing policy, rather than the legal form. However, it is critical that any measures adopted by the OECD are workable, well targeted, and do not result in unintended consequences that negatively impact the efficiency of commercial insurance operations and the availability and cost of insurance coverage for consumers. In particular, given the highly regulated nature of the insurance industry, particularly with respect to capital requirements, any changes affecting capital would have a negative impact on the availability and cost of insurance, given the importance to insurers of being able to diversify portfolios through reinsurance.

General comments

The GFIA agrees that comparability is at the heart of the arm's length principle, and that the accurate characterisation of transactions together with identification of comparable transactions between unconnected parties is essential. The GFIA welcomes the guidance set out in Part I of this document in terms of understanding what best practice might look like.

The GFIA believes however that some considerations presented by the discussion draft do not apply to the insurance industry. The GFIA believes that the 2010 OECD Report on the Attribution of Profits to Permanent Establishments Part IV (Insurance) ("Part IV") continues to be relevant to the discussions about transfer pricing and the allocation of risk in the highly regulated insurance context. Referencing Part IV would be the best approach to providing guidance on risk transfers for the insurance industry, given the time and effort which has already been invested in the development of Part IV and the very tight time constraints in finalizing the BEPS initiatives.

Any discussion about risk and capital in insurance should take into account the fact that regulators in all jurisdictions require insurers to hold an appropriate amount of capital in order to ensure that policyholder claims can be paid out in all circumstances. The precise amounts depend on the regulatory regime in question. But in

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all situations this is the minimum amount of capital that would be held by the insurer. In addition to regulatory capital requirements, ratings agencies impose additional conditions to satisfy credit rating requirements. For insurers, the rating applied is also critical as certain types of investors may only be able to invest in entities with a prescribed credit rating or higher. Therefore, the maintenance of an appropriate level of capital within a jurisdiction is not a business choice, open to flexibility depending on the tax treatment of debt but instead it is critical to an insurer's ability to carry on business. Insurers typically hold additional capital in excess of the minimum capital amount as a buffer. The tension between the flexibility of this approach in writing business and paying out claims versus the cost of holding capital of sufficiently high quality such that it qualifies as 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.

Specific comments

Question on page 15 regarding the Financial Services Sector & On-going Relevance of the 2010 OECD Report on the Attribution of Profits to Permanent Establishments Part IV (Insurance)

Page 15 of the discussion draft raises the following question with respect to the financial services sector: *Is the discussion of risk of a general nature such that the concepts apply to financial services activities notwithstanding the fact that for financial services activities risk is stock in trade and risk transfer is a core component of its business? If not, what distinctions should be made in the proposed guidance?*

The GFIA has a number of concerns regarding some of the comments made by the discussion draft. Our concerns relate to the extent to which these considerations apply to the insurance industry.

For example, the discussion draft notes that: *"Between third parties, the assumption of risk without the control exerted by management over the risk is likely to be problematic because (i) it is difficult for the party assuming risk to evaluate the required additional expected return when the factors affecting the risk outcomes are determined by another party; and (ii) there would likely be considerations of moral hazard in an arm's length situation were one party to assume risk without safeguards to manage the behaviour of the party creating its risk exposure. In arm's length transactions it generally makes sense for the parties to be allocated a greater share of those risks over which they have relatively more control. "*

This does not hold for insurance since, unlike in other industries, insurers *do* take on risks over which they do not have a lot of control and this is fundamental to the insurance business. Insured parties pay an insurance premium to reduce their exposure to risks; the insurer pools the risk to distribute the contingency of loss and holds the necessary capital to cover any volatility. The insurer prices the contract to reflect the risk level (higher premiums indirectly encourage the insured to manage and reduce the risks where possible). Insurers manage their risks by diversifying their own portfolios, by writing more business and/or through reinsurance (which effectively provides insurance to the insurance company). The statement that parties should be "allocated a greater share of those risks over which they have relatively more control" is not applicable in the insurance industry. Instead, risks should be allocated to the parties capable of accepting and managing the risk and who hold sufficient capital to cover the associated volatility.

Part IV recognizes that the KERT for insurers is the assumption of insurance risk/business (see for example **paragraphs 93**[1] **and 94**). Part IV provides comprehensive guidance defining and discussing risks, risk management and allocation of risk in the context of insurance businesses. Accordingly, referencing Part IV would seem to be the best approach to providing guidance on risk transfers for the insurance industry, especially given the time and effort which has already been invested in the development of Part IV and the very tight time constraints in finalizing the BEPS initiatives.

Paragraphs 88-93 discuss the effects of non-recognition of a transaction. The GFIA does not see the added value of this solution as it creates a lot of uncertainty for taxpayers. In the GFIA's view, the current set of rules and proposals should be adequate to establish the correct price. The issue of the example made in **paragraphs 90 and 91** could be resolved by adjusting the royalty payment to reflect the functions performed, risks taken and assets used without fully discarding the element of capital put in the equation. The GFIA believes that tax authorities should only make use of this instrument as part of a direct consultation between the tax authorities that could be linked to a mutual agreement procedure. In particular, **paragraph 93** deals with consequences of non-recognition and seems to suggest that a new functional analysis has to be made of the transaction, which raises the question what the added value of a non-recognition would be in the first place. Specific consideration should be given to dispute resolution mechanisms.

Generally, much of **paragraphs 43-59** which discuss allocating, assuming, and managing risks and the potential impacts of risks are not relevant for the highly regulated insurance industry. Accordingly, the GFIA welcomes the following comments:

- **Paragraph 66:** "MNE groups, *unless subject to capital adequacy regulations*, can determine the capital structure of subsidiaries without explicit consideration of actual risk in that subsidiary. For the same reason, a low level of capital in a controlled enterprise should not prevent the allocation of risk to the company for transfer pricing purposes where such allocation is justified under the guidance of this Chapter." (emphasis added)
- **Paragraph 86** which notes that regulated entities are subject to significant restrictions such that they do not have "freedom to control their structures, including shareholding, capitalisation, and legal form".

With respect to **paragraph 66**, the GFIA also notes that the last sentence is not applicable in the highly regulated insurance context, since enterprises with a low level of capital will not have sufficient regulatory capital to accept additional risk.

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[1] Paragraph 93 of Part IV states in unequivocal terms: *All facts and circumstances need to be considered to determine which function assumes insurance risk for the enterprise, because the assumption of insurance risk is the key entrepreneurial risk-taking function for an insurance enterprise. Other functions performed by an insurance enterprise may be important and valuable functions and should be compensated accordingly, but these other functions are not functions that form part of the key entrepreneurial risk-taking function.*

Paragraph 67 states: "Third parties may be unlikely to provide insurance for core competencies unless they have significant information about and control of potential outcomes due to moral hazard that the incentive to manage risk by the insured party is lowered."

This statement is not applicable for insurers as they do provide insurance for core competencies (for example professional indemnity insurance as well as the reinsurance market) although the price charged will reflect the level of risk assumed and may also be dependent on risk management activities in the insured entity. However, any insistence on such risk management activities is likely to fall short of "significant information about and control of potential outcomes". The GFIA suggests that this sentence be amended to make it clear that it does not apply to the insurance/reinsurance industry.

The final sentence of **paragraph 78** states: "A party which does not control risk will not be allocated the risk and therefore will not be entitled to unanticipated profits (or required to bear unanticipated losses)."

As mentioned previously, in the insurance context, the insurer generally does not control the risk, but instead prices for the level of risk assumed. As noted in Part IV, risk assumption is the KERT for the insurance industry, and as such, the insurer would therefore be "entitled to unanticipated profits (or required to bear unanticipated losses)".

Retrospective Approaches: The GFIA is concerned that the discussion draft includes a number of cases[2] where retrospective reviews of arrangements are noted. Third parties enter into transactions based on the information available at the time, which is consistent with the existing Transfer Pricing Guidelines. If the actual results are different from the expected results, which would often be the case, third party contracts are not generally revised retroactively, rather they are renegotiated on a go-forward basis (assuming both parties are in agreement). Accordingly, the GFIA has strong concerns that retrospective approaches will not produce results consistent with arm's length transactions. Furthermore, such approaches would generate a fiscal result different to that arising for regulatory, contractual and accounting purposes. A retrospective adjustment to an arm's-length transaction would expose an individual insurance company to an unexpected tax charge that would suddenly deplete its regulatory capital and potentially impair the ability to pay legitimate claims to policyholders. The GFIA thus recommends that any adjustments for additional transactions should be limited to situations where there would be adjustment in transactions between third parties.

Paragraph 7 discusses unidentified MNE transactions which result in a transfer of value between parties. Explicit reference is made to a provision of know-how via a seconded employee. In the GFIA’s view, it is virtually impossible to make a distinction between deploying the skillset of an employee for the benefit of the host country business (like any other employee) and a transfer of know-how for transfer pricing purposes. The same effect would likely be obtained by hiring an individual from say a competitor (i.e. the transfer of know-how is reflected in the remuneration of the individual). The GFIA would therefore welcome a further clarification on this example.

[2] For example, see paragraphs 5 and 7 of the discussion draft.

Paragraphs 12 -14 describe the manner in which independent enterprises decide whether or not to enter into a specific transaction. This implies that an enterprise can compare and freely choose between service providers, making a distinction between them on the basis of (for example) prices. This however might not always be the case in an MNE, where certain services may be centralised and provided at a cost level which is considered normal in country X, but lies above the cost level which would be normally acceptable by a member of the group resident in country Y. In other words, commercially, the transaction adopted may not always be the best opportunity for the service recipient.

Clarification Regarding Insurance Comments in Paragraph 18

Paragraph 18 includes the following insurance example: *"18. [New] In other situations, the controlled arrangement may require reduced capabilities to what might typically be required in uncontrolled arrangements. For example, an independent insurance provider offers diversification that the party seeking insurance may not have. However, in a group situation, the group may already have a wide range of assets in a range of locations such that some of the value of diversification that is implicit in the insurance premium charged by an independent insurer is already provided by the group companies. The additional capabilities the group may have in this situation will likely lead to a different fee to that charged by an independent insurance company to a customer lacking such attributes."*

It is not clear what point this example is trying to make so the GFIA would suggest that it be deleted. For example, is it suggesting that there would be a group volume discount i.e. that if the whole group purchased insurance from the same insurance company (or under a global master policy), it would be cheaper than if each company purchased insurance individually? For full geographic diversification, the assets would need to be in different countries. In that case, due to regulatory restrictions, each risk would likely be insured by a local insurance subsidiary, so pooling benefits of geographic diversification would be minimal, and would only be achieved to the extent the insurance group subsequently reinsured the risks centrally to another group company.

Response to Question 4 on Page 14: *Under the arm’s length principle, should transactions between associated enterprises be recognised where the sole effect is to shift risk? What are the examples of such transactions? If they should be recognised, how should they be treated?*

The fundamental nature of the insurance industry is to shift risk. Accordingly, insurance and reinsurance transactions between associated enterprises should be recognised (and be priced on an arm's length comparable basis).

Special Measures

In general, the GFIA believes that clear criteria for the application of special measures need to be established, so that the measures can be applied consistently by tax authorities. Special attention needs to be given to devising a mechanism which eliminates the potential of double taxation in situations where transactions/entities are caught and tax has already been assessed in the other jurisdiction.

- Option 1 introduces retrospective tests and steps away from the arm's length principle. The GFIA believe that if initial arrangements took account of all information available at that time then no subsequent adjustment should be made in the event that the actual results differ from the budgeted results.
- Option 3: Thick Capitalisation would not be appropriate in the highly regulated insurance sector where regulators already require insurers to hold sufficient capital to protect policyholders and ensure the on-going viability of the business.
- Option 4: Minimal function entities. The GFIA agrees that to be viewed as a minimal functional entity the "company in substance performs mainly routine functions", but the GFIA thinks that statements about the number of employees introduce confusion. The GFIA would suggest that the drafting of the measures should be such that it is clear that no one qualitative or quantitative measure alone should be a decisive indicator of minimal functionality. The test of minimal functional entity should recognise that:
    - Many insurance groups have single employer entities in their head office and main operating locations, typically due to regulatory constraints or preference and/or reasons of employment law and operational efficiency. Functions are often performed internally and are then supplied by arm's-length agreement to the receiving entity. There is a genuine function performed, but the employer entity is different for non-tax reasons.
    - Certain functions may be outsourced to cheaper developing countries, in order to obtain the cost efficiencies which ensure basic insurance premiums remain competitive. Such activity should not then be penalised by the application of a minimal function entity adjustment. The GFIA recommends that these outsourced employees be included in the test as performing the function they actually undertake.
- Option 5: Ensuring appropriate taxation of excess returns is more a CFC rule than a transfer pricing one and the GFIA does not believe that transfer pricing actions could prevent excess returns in low tax jurisdictions. The GFIA suggests this issue can be better addressed under Action 3.

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About the GFIA

Through its 38 member associations, the Global Federation of Insurance Associations (GFIA) represents the interests of insurers and reinsurers in 58 countries. These companies account for around 87% of total insurance premiums worldwide. The GFIA is incorporated in Switzerland and its secretariat is based in Brussels.