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GFIA Comments on OECD Discussion Draft on BEPS Action 3: Strengthening CFC Rules

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 Action 3: Strengthening CFC Rules (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 policy objective of the discussion draft to "develop recommendations for CFC rules that are effective in dealing with base erosion and profit shifting". However, it is critical that any measures adopted by the OECD are workable, well targeted to only apply to cases of base erosion and profit shifting, 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, we are concerned that the discussion draft's broad reach, which is not limited solely to base erosion and profit shifting, will negatively impact the availability of capital, which in turn will negatively impact the availability and cost of insurance, given the importance to insurers of being able to diversify portfolios through reinsurance.

General comments

The proposals in the discussion draft are complicated and conflicting, partly because they need to address both worldwide and territorial tax systems, which has resulted in inconsistencies due to the fundamental differences between the two approaches. It is not clear how the recommendations in the discussion draft interrelate with the other BEPS Actions, making it difficult to consider these recommendations in isolation.

The insurance industry is highly regulated for the protection of customers. GFIA therefore believes that any recommendations should not result in CFC income being attributed with respect to insurance where there is economic and value creating activity. The GFIA believes that the 2010 OECD Report on the Attribution of Profits to Permanent Establishments Part IV (Insurance) (“Part IV”) is highly relevant to the discussions about the attribution of income in the highly regulated insurance context. Referencing Part IV would be the best approach to dealing with 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.

The draft needs to recognize the critical role of capital in the insurance sector. Any discussion about capitalization in the insurance industry needs to 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 in all circumstances. The precise amounts depend on the regulatory regime in question. But in all situations this

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is the minimum amount of capital that must be held by the insurer. In addition to regulatory capital, ratings agencies impose additional conditions to satisfy credit rating requirements. Insurers' credit rating and financial strength is critical since:

- most customers will only place their business with a financial institution with a strong credit rating
- some investors are only able to invest in entities with a prescribed credit rating or higher
- it allows them to attract capital at a reasonable cost.

Insurers typically hold additional capital in excess of the minimum regulatory capital as a buffer to ensure they have sufficient capital to write new business and pay out claims. Insurers need to ensure they hold capital of sufficiently high quality such that it qualifies as regulatory capital, which is constantly managed. The ability to manage capital efficiently is a key source of competitive advantage in the sector. The maintenance of an appropriate level of capital within a jurisdiction is critical to an insurer’s ability to carry on business – it is not primarily a tax-motivated decision.

Specific comments

Economic Benefits of Insurance and Reinsurance

Insurers create value for the economy as a whole by assuming risks, which may be catastrophic, from businesses and individuals, in return for an insurance premium. The benefits of spreading risks over a large number of policyholders significantly reduce the cost of insurance. Insurers actively manage the risks they take on, using reinsurance to diversify and manage their risks and to generate capital efficiency. For insurers, the pooling and diversification of risk is crucial to their business, which is recognised both by rating agencies and regulators. Multinational insurers manage risk on a global basis using reinsurance. Pooling of insurance risk in one entity in the corporate group facilitates the purchase of external reinsurance. This allows the insurance group to efficiently transfer global risk to third party reinsurers. The group's efficiency is maximized through centralized pooling of risks from different lines of business across geographies, leading to global diversification of risks with optimal use of capital (a scarce resource) and improved risk management. This optimization reduces the requirements for costly external reinsurance.

The insurance industry is highly regulated and insurers are required to maintain sufficient capital to protect policyholders. Capital is needed for growth and writing new business. Reinsurance is also an effective method of providing capital to subsidiary insurance companies, since regulators can give significant credit for intra-group reinsurance, in recognition of the real transfer of risk. The insurer’s regulator will only agree to the risks being transferred and to the attendant capital reduction if it is satisfied that the reinsurer has the capital and capability to assume and manage the risks. Similarly, the reinsurer’s regulator will only allow the reinsurer to accept the risk if it is satisfied that the reinsurer has the capital and capability to assume and manage the risks. As a result, there are two independent regulators who need to be satisfied that the risks have indeed been transferred to the reinsurer.

Inconsistencies Between Discussion Draft and Part IV

Part IV includes an extensive discussion of the attribution of profits in the insurance and reinsurance sectors. As noted in Part IV, "the assumption of insurance risk is the key entrepreneurial risk-taking function for an insurance enterprise", although other elements will also be relevant, and may be located in different jurisdictions or entities, depending on the specific facts and circumstances.[1] Part IV goes on to say:

> Once a location performing the insurance risk assumption function has been determined and the respective insurance risk has been attributed to it, it will be necessary to attribute an appropriate amount of assets to that location to back that risk (*i.e.* assets representing both reserves and surplus). Further, it will also be important to reward other functions in accordance with the arm's length principle. It should also be noted that there is no presumption that these other functions are by nature of low value. This will be determined by the functional and comparability analyses based on the particular facts and circumstances. A whole spectrum of rewards from performing these other functions can be expected ranging from, at one end, low value rewards to at the other end rewards based on a share of the residual profit of the part of the enterprise acting as the key entrepreneurial risk-taker. In short, the functional and factual analysis determines the attribution of profits to the PE in accordance with its functions performed, assets used and risks assumed, and informs also the attribution of assets and investment income to the PE.[2]

Accordingly, we urge that the OECD's recommendations take into account the unique commercial realities of the global insurance business model. We are concerned that the discussion draft does not better distinguish insurance and reinsurance income from other types of income that CFC rules must be capable of dealing with, such as dividends, interest and other financing income, sales and services income, royalties and other IP income.[3] We strongly agree with the following statement in paragraph 85 of the discussion draft (emphasis added):

> Accurately attributing this income does not mean that CFC rules should include all of this income in CFC income. It instead means that, at a minimum, CFC rules should attribute income that raises BEPS issues within each category and *should not attribute income that arises from value-creating activity in the CFC jurisdiction*. *If CFC rules are designed to apply only to stripping of the base of the parent jurisdiction, then income should not be attributed if it arises from value-creating activity in any jurisdiction other than the parent jurisdiction*.

[1] See, in particular, paragraphs 68, 69, 93 and 94 of Part IV.

[2] Paragraph 71 of Part IV.

[3] See paragraph 84 of the discussion draft.

Paragraph 102

Paragraph 102 of the discussion draft states:

> "The general concern underlying the treatment of income from the insurance of risks is that profits can be shifted away from jurisdictions in which those risks are located and into a low-tax jurisdiction. For example, an insurance company that is licensed to carry on an insurance business in a particular jurisdiction may underwrite insurance policies in respect of persons or businesses located in that jurisdiction and then reinsure some or all of these risks to a CFC that is resident in a low-tax jurisdiction (and that is generally not licensed to carry on an insurance business in the particular jurisdiction), thereby shifting profits associated with the insurance of those risks. In addition groups that are not generally involved in insurance activities may establish "captive" insurance companies (often in a low-tax jurisdiction), and by various means insure risks associated with the groups normal business activities with the captive insurance company, thereby shifting profits to the captive insurance company. Generally speaking, little activity is required in the management of these reinsurance operations or these "captive" insurance operations."

In regard to paragraph 102, we would like to emphasize that:

1) As noted previously, it is important to distinguish between the location of the CFC's functions (including risk assumption and risk management) and assets and the location of the related risks. Profits that are properly attributable to the jurisdiction(s) in which key entrepreneurial risk-taking functions are carried on, and through which capital is committed and put at risk, should not be considered to be "shifted away" from any other location, as that would be inconsistent with Part IV.
2) The fact that some profits may be properly attributable to "a low-tax jurisdiction" should not raise BEPS concerns because they do not reflect "cases of no or low taxation *associated with practices that artificially segregate taxable income from the activities that generate it*"[4] (emphasis added). Of course, the insurance or reinsurance coverage must be properly priced. The jurisdiction in which the risk is located receives valuable benefits resulting from the efficient operations of the insurance market through the spreading and diversification of risk.

Question 11 for consultation

11. How can CFC rules accurately attribute income that raises concerns about BEPS (i) in a business that is licensed under an appropriate regulatory body and is market-facing in a particular jurisdiction, (ii) in a reinsurance business carried on by a CFC of a multinational insurance group or (iii) in a "captive" insurance business of a CFC that is not part of an insurance group? Are there practical problems with current rules that distinguish between (ii) and (iii)? If so, what are they and how can they be dealt with?

[4] Action Plan on Base Erosion and Profit Shifting (OECD "Action Plan"), page 13.

In our view, insurance that creates real economic value does not give rise to BEPS and should therefore not be subject to the CFC rules. Key features to identify reinsurance that creates real economic value include the following:

- the underlying risk involves third party risks outside the corporate group
- the reinsurance contract is priced on an arms' length basis
- insurance is written on a global basis. This enables diversification and pooling of risks in the reinsurer
- the entity has a real possibility of incurring losses
- the entity has the expertise to assume and manage risk in the form of underwriting and actuarial professionals (or such services are available in a related service company). In evaluating whether an entity has sufficient expertise it should be noted that:
    - Reinsurers require significantly less employees than an insurer since there are significantly less contracts to manage (this should be considered in any evaluation of substance under an "employees and establishment analysis" as described in paragraph 89 of the discussion draft).
    - Although insurance groups employ staff in the territories in which they operate, these employees may be employed by a service company of the insurance group. This is a common business model in the insurance sector and is often due to regulatory requirements (for example, EU Life Insurance and Non-Life Insurance Directives).

Paragraph 112

Paragraph 112 suggests that, under a categorical approach, "*Income from insurance will generally be treated as active (and therefore excluded) unless (1) the income was derived from contracts or policies with a related party or (2) the parties to the insurance contract or the risks insured were located outside the CFC jurisdiction. However, income from insurance that falls under these two exceptions will only be treated as passive (and therefore included) if the CFC was overcapitalised or did not have sufficient substance to assume and manage the risks on its own accord."*

Given the importance to insurers of capital and the needs for geographic diversification to spread risks, we do not believe that the requirements above are appropriate since:

1. **any concerns about related party reinsurance should more appropriately be dealt with through transfer pricing rules**, and
2. the requirement that the parties to the insurance contract or the risks insured be located outside the CFC jurisdiction is inconsistent with the need to manage and reduce risks on a global basis through geographic diversification.

In addition, from a practical perspective, there are uncertainties as to how any such rule would apply in practice. For example, it is not clear how "sufficient substance" would be determined in the insurance context. As noted above, any determination of substance should take into account that:

- reinsurance operations require less appropriately qualified staff (such as actuaries and underwriters etc.) to assume and manage insurance risk than direct writers since there are significantly less contracts
- due to regulatory requirements, or other business reasons, staff in the territory may be employed by a service company of the insurance group.

In addition, it is not clear how overcapitalization should be measured for insurers – consideration needs to be given to the fact that, as mentioned previously, insurers need to hold capital in excess of the regulatory capital. It is important to note that insurance operating subsidiaries are in general not overcapitalised since it does not make commercial sense for a subsidiary of an insurance group to hold excess capital, even where the subsidiary is in a low tax territory. Any capital above what is needed for the insurance operations will be passed up to the parent company, to ensure capital can be deployed quickly if needed in another territory to support sales and generate income in other territories.

Excess profit approach

Insurance results (profits/losses) are volatile since they depend on uncertain future events. At the time a reinsurance contract is signed, it is not known whether a profit or loss will ensue and the timing of profit/loss recognition is uncertain. Accordingly, an excess profit approach is completely inappropriate for insurance income.

Recognition of Insurance Losses

Insurance income is fundamentally different from the other forms of CFC income (dividends, interest and other financing income, sales and services income, royalties and other IP income) since an insurance business can generate profit or losses, whereas the other forms of CFC income generally do not have losses. Given that losses can arise in the insurance business, relief should be available for any losses to either be set off against other CFC profits in the same territory in the same year or to be carried forward in the CFC against profits in later years.

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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.