

Newsflash

TAX

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The OECD has published a revised draft of Part IV of its report on the Attribution of Profits to Permanent Establishments. Part IV deals with insurance enterprises, and the latest draft follows the finalization of Parts I-III in December 2006, which considered the general considerations governing the OECD's Authorized Approach to the taxation of permanent establishments ("PE's") and their application to traditional banking and global trading.

In its continuous effort to keep its clients updated on current tax developments, KPMG would like to inform you of the following:

Introduction

The report represents one of the most important contributions of the OECD to the field of transfer pricing in recent years. Fiscal authorities have increasingly looked to the taxation of PEs, including formally constituted branches and "dependent agents", as a means of protecting their tax base in the face of the ever-increasing globalization of business. However, differences in interpretation of the arm's length standard between taxing authorities have led to uncertainty for business, double taxation, and a rise in both litigation and appeals to competent authority.

The project to develop new guidance under Article 7 of the OECD's model tax convention began in 2001 and has been the object of several public consultations, including one specifically addressed to the insurance industry which took place in Paris in 2006. The insurance industry has been particularly concerned by a number of aspects of the previous draft of Part IV, and will be studying the latest draft closely to see how the OECD has responded to those concerns.

The OECD has invited written comments on the latest draft to be submitted by 31 October 2007 and proposes to hold a consultation meeting with commentators in Paris on 26 November 2007 prior to finalizing the report.

Implementation will form part of a package of measures including a

This Newsflash aims to provide the reader with general information on the above mentioned matters. No action should be taken without first obtaining qualified professional advice specifically relating to the factual circumstances of each case.

revised commentary on the existing Article 7, which was published in draft on 10 April, and a new Article 7 and accompanying commentary which are expected later this year.

The latest draft is published at a time when institutions with a US presence are considering the impact of transfer pricing and permanent establishment issues on their obligations under US financial reporting standard FIN 48.

KPMG sets out below the headline issues in the revised Part IV, and invites you to contact one of our dedicated financial services transfer pricing specialists for further information.

Headline issues for insurance groups

Reinsurance between associated enterprises - Section C of the previous draft of Part IV dealt with insurance companies operating through subsidiaries and has now been completely removed. This will be welcomed by the industry; the comments in Section C of the previous draft were among its most controversial aspects as they appeared to invite tax authorities to recharacterize these transactions rather than focus on whether they are priced at arm's length. There was much concern that the role of reinsurance within the industry and within groups in particular had been misunderstood. The OECD has responded by reiterating the focus of the report, which is the attribution of profit within a single legal entity. It is important to note, however, that Part IV in common with Parts II and III contains a valuable analysis of the functions, assets and risks of an insurance enterprise which will also be relevant

when considering transactions between different members of the same group. It should also be borne in mind that the language of the previous draft Section C may reflect the views of the tax authorities in certain member states, and that the revised draft simply sets these matters aside as out of scope rather than provide a more balanced view of the role of intra-group reinsurance.

No other major concessions - with the exception of Section C, the consultation process has led to the clarification of some points and the refinement of the drafting, but those hoping for significant concessions or dramatic changes of direction will be disappointed.

KERTs - Part IV is consistent with the earlier parts of the report in emphasizing the role of the key entrepreneurial risk-taking (KERT) functions in determining where risks and the associated assets and investment income should be attributed. In keeping with the final versions of Parts I - III, it is flexible about which functions should be regarded as KERTs in specific circumstances, which is to be welcomed. In some cases, for example, the marketing function may be recognized as a KERT. Furthermore, the report stresses that those functions which are not KERTs should not automatically be assumed to be of low value, and in some instances should be rewarded with a share of the residual profit. Nevertheless, "people functions" and not capital remain the starting point for the attribution of profit within a single enterprise. Also, Part IV now departs from the analysis in Parts II-III in that it only recognizes one kind of KERT, that of risk assumption. As noted above

there is some flexibility regarding what constitutes the KERT of risk assumption, although this will normally be the underwriting function. However, Parts II - III recognize ongoing risk management as a second KERT. In a significant change from the earlier draft Part IV is explicit throughout that, in insurance, risk management does not involve sufficiently active decision-making to constitute a KERT.

Intra-entity or "internal" reinsurance - the report concludes that reinsurance between different parts of the same legal entity should not be recognized. This results from the previous conclusion that only risk assumption constitutes a KERT in the insurance industry.

Impact of regulation - while recognizing the importance of regulation within the industry, the report rejects the use of regulation as the sole determinant of where insured risk is accepted for a variety of reasons, describing the regulator's position as "persuasive but not determinative".

Attribution of investment assets rather than surplus and reserves - the revised report concludes that, rather than separately determine the surplus and reserves to be attributed to the PE, it is necessary to attribute the investment assets which represent the surplus and reserves together. This results from the lack of an internationally accepted standard for determining either the amount of reserves or the level of surplus to be maintained for a particular pool of risks, whereas the report finds that local requirements tend to converge in determining the total investment assets to be maintained. As

with the attribution of capital in Parts I – III, more than one approach is authorized to the attribution of investment assets. Either the total investment assets of the enterprise are to be allocated among the different PEs (analogous to the capital allocation approach in Part II) or the investment assets are to be determined by reference to those required by an independent insurance company with similar activities, assets and risks under similar conditions (analogous to the thin capitalization approach under Part II). A third method based on the minimum regulatory requirements of the host country (analogous to the quasi-thin capitalization approach under Part II) is only available to be offered as a safe harbor by the host country tax authorities, as it may result in the host country taxing less than an arm's length amount of investment income.

Investment yield on surplus and reserves - once surplus and reserves have been attributed to the PE, it will be necessary to determine the corresponding investment yield. This will require assumptions to be made according to the facts and circumstances regarding the type of assets the PE would hold were it a separate enterprise. The report proposes two approaches to determining the return on any assets attributed to the PE under the authorized approach in excess of those held in the host jurisdiction, a "top-down" approach based on the return to either the total investment assets of the enterprise or the "uncommitted" assets outside the host jurisdiction, or a "bottom-up" approach based only on the return to assets held in the host jurisdiction. Clearly this will be an area in

which the move toward creating a "tax balance sheet" will give rise to significant issues.

Dependent Agent Permanent Establishments - the report recognizes that insurance is often sold through agents in a foreign country but, in keeping with Parts I - III, Part IV makes clear that the report does not address the threshold for creating a PE; it takes as its premise that a PE exists under Article 5 of the OECD Model Convention and considers the measure of profits to be attributed to the PE. Nevertheless, as in banking and global trading, the findings of the report are likely to lead to a renewed focus on whether common structures in the industry give rise to a PE, and in particular a dependent agent PE ("DAPE"). As in Part III, the report concludes that in attributing profits to the DAPE, there are likely to be profits over and above the arm's length service fee paid to the dependent agent enterprise.

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