Position Paper

Position on the OECD's programme of work to develop a consensus solution to the tax challenges arising from the digitalisation of the economy

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This paper outlines a number of principles that the insurance industry believes must be taken into account by the OECD and G20 in their work on the Inclusive Framework on BEPS ("IF") as they continue to focus on their "Programme of Work to Develop a Consensus Solution to the Tax Challenges Arising from the Digitalisation of the Economy" ("Programme of Work"). Insurance Europe has limited its comments on the proposals under Pillar 1, as it continues to assess the potential implications of Pillar 2 proposals for the European insurance industry.

Insurance for the global economy

Insurance is crucial to the successful operation of the economy and to global investments and growth. (Re)insurers play a unique role in the global economy, protecting individuals, businesses and governments against financial loss from risks ranging from natural catastrophes to poor health and unemployment. Insurance business is all about the transfer of risk between the insured party and the (re)insurance company. In exchange for the payment of a premium, an insured party can transfer the risk of loss from a particular source to a (re)insurer. By pooling the risks of multiple insured parties, the (re)insurer can spread the risk of loss. To ensure that it will be able to pay any claims that arise beyond those expected, the (re)insurer holds an appropriate amount of capital.

For (re)insurers, risk and capital cannot be separated; there can be no assumption of risk without the provision of appropriate capital in an insurance context. The regulatory capital rules which (re)insurers are subject to are designed to ensure that the company bearing the risk of the loss has the capital available to meet such losses.

Comments relating to the OECD's proposals under Pillar 1

Insurance Europe understands that discussions are continuing on a unified approach to addressing the issues of profit allocation and nexus. However, the expected outcome of Pillar 1 is the allocation of more taxing rights to market jurisdictions (the jurisdiction of the customer and/or user) in situations where value is created by a business activity that is not recognised in the current framework for allocating profits.

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Insurance Europe notes from Paragraph 24 of the programme of work, that Pillar 1 is focused on determining the amount of profits subject to the new taxing right and the allocation of those profits among jurisdictions.

It is suggested in Paragraph 37 that not all businesses will be in the scope of the programme of work. In particular, Paragraph 37 notes that "the programme of work would explore issues and options in connection with design scoping limitations" and goes on to say that "it would also include an evaluation of rules that could focus the scope of the rules on businesses that are of a type to which the rules should apply."

Why is insurance not of a type to which the rules should apply? Why is it different? **It is the industry's position that for the reason outlined below, insurers have to be excluded from the scope of Pillar 1 in the programme of work.**

The (re)insurance industry's business model makes it less relevant to the objectives of Pillar 1 than other industries, which means (re)insurance does not need to be included in the scope of Pillar 1.

- (Re)insurance is highly regulated in a way which requires local capital to be held to match local risks, plus a margin for additional security. A licence to conduct insurance business will not be granted if local regulatory requirements are not met.
- (Re)insurance income streams are volatile and can result in substantial losses in any specific period, especially in a location where risk is pooled. The concepts discussed under Pillar 1 assume regular (super)profits, and do not provide specific rules regarding how such losses would be reallocated.
- It is illegal in many countries to sell insurance if there is no local regulated, and thus taxed, presence.
- Insurance groups are often multinational, and reinsurance groups always multinational, but the business model is based on companies with (most often) a local physical and hence taxable presence, as insurance companies need to be close to their customers. As such, taxing rights are already largely with the jurisdiction of the consumer.
- Data is important to (re)insurers and they use data from numerous sources, but (re)insurance is not a highly-digitalised business model.
- While (re)insurance is a service, the purchase of insurance is already subject to indirect taxes based on location of risk (largely the location of the user).
- There are significant identification and measurement issues for (re)insurance companies in the context of Pillar 1 that are different from other industries.
- The current arm's length principle ("ALP") system allocates taxing rights for insurance business to the appropriate jurisdiction. This is reflected in the fact that insurance already has detailed guidance under Part IV of the OECD's report on the attribution of profits to permanent establishments: eg, investment return on assets is already allocated to the location where the insurance company has the insurance risk.
- Insurance does not have super profits arising from intangibles, which is why it's not impacted by the recently created digital service taxes.

Insurance business model and value chain

(Re)insurance companies' business models focus on the assumption and management of risk. The (re)insurance business model is based on companies with local presence supported by diversification of risk, which is often global. (Re)insurance companies manage the level of risk they retain through diversification either through writing additional, often uncorrelated, business or via reinsurance (retrocession). The (re)insuring operations conducted by a local subsidiary or branch of a global insurer can vary in terms of scope and function. However, due to the nature of insurance activities, the primary types of income derived by insurers (for example, payment by the policyholders for protection of risks) are largely dictated by market conditions in that jurisdiction.

Companies will often engage in reinsurance to reduce the risk that they assume in a specific line of business or specific geographic territory. "Reinsurance" is insurance that insurance (and reinsurance) companies buy to protect themselves from excess losses that could arise from events such as earthquakes, hurricanes, epidemics etc. Reinsurance is an integral component of insurance companies' business models, providing them with the ability to manage the risk that they assume, often before a decision is made to write the business. Reinsurance can be used to increase capacity so that the insurance company does not have to decline business, to facilitate the growth of an insurer's new products or aid entry into new lines of business. This in turn helps them to manage their capital position.

For insurance, most of the business is local and where there is cross-border insurance and reinsurance, regulation continues to require capital be located with the risk. In most cases, insurance companies need a local market presence for market access, to enable them to be close to customers and brokers and meet the regulatory requirements to sell insurance.

In cases where a (re)insurance's relationship manager facilitates services in another jurisdiction provided by a foreign branch or subsidiary, the foreign (re)insurer entity providing the service to the customer would normally be operating under a licence in that jurisdiction and would have an existing taxable presence. That entity would be expected to derive an arm's length profit margin commensurate with the risks assumed and functions performed in providing the service.

The footprint of an insurance company is important to serving customers. Insurance companies generally do not have scale without the requisite mass and do not participate in the economic life of a jurisdiction without an associated or meaningful economic presence.

Insurance companies have substance in the jurisdictions in which they operate: capital is held in those companies and the appropriate number of people are employed. While different business models need different numbers of people, insurance always requires highly qualified employees to assume and manage risk. In fact, this is one of the tests of the substantial activities standard as determined by the OECD Forum on Harmful Tax Practices.

Each risk bearing entity within a (re)insurance group operates as a separate legal entity and is regulated in that way by local regulators (in Europe via the home state regulator). The regulatory environment has been put in place to offer protection to policyholders and places constraints on the entity structures that are acceptable. Generally, regulators want to regulate operations that are local to them, both in terms of the product sold and to ensure the insurer has enough capital to pay all due claims, even after a major catastrophic event.

By design, the taxing rights are largely with the jurisdiction of the consumer.

Regulation and capital adequacy

The ability for a (re)insurance entity to assume risk is governed by regulation and (re)insurance groups are required to operate within very specific regulatory constraints. The key area of focus for regulators in a (re)insurance context is the amount of capital held. Each regulated entity is required to have sufficient capability and capital in their local (or host state for passported entities within the EU) regulated territory to manage risk assumed. The location of the assumption of insurance risk is therefore also the location where the capital relating to that business is held. Similarly, there are constraints on the movement of capital within structures and therefore the location of risk and capital will generally have to reflect the economic activities carried out.

The balance between risk and capital is critical for a regulated (re)insurer. Capital has a high cost for insurers, as regulators force insurers to hold high-quality capital in excess of expected liabilities and limit the amount and type of debt that may be included in regulatory capital. In addition to regulators,

rating agencies, analysts and other external bodies that measure capital adequacy will impose discipline in this area. Local capital requirements ringfence the risk capital and thereby the non-routine profit is already allocated to the different market states.

Regulation and the need for specific types of capital in each regulated entity are additional reasons why taxing rights are already largely with the jurisdiction of the consumer.

Volatile income streams and losses

A (re)insurer assumes a variety of risks in relation to the business it writes. One of the main risks for a (re)insurer is underwriting risk which is the risk of premiums paid by policyholders not being sufficient to cover claims and expenses. The payment for protection of risks that may never materialise is core to insurance industry pricing. Protection from risk has economic value even if the risk never materialises.

However, underwriting risk is inherently unpredictable and can be impacted by factors that are beyond the control of the (re)insurer and result in claims that exceed premiums and other income and the (re)insurer makes a net loss. Examples of these factors include severe or frequent natural disasters such as earthquakes, hurricanes and other storms and floods as experienced in 2017 and 2018 when substantial underwriting losses occurred.

The selection and pricing of underwriting risk is the core business of (re)insurance and over time is forecasted to give positive returns, but this cannot be guaranteed in any specific time period. It is very difficult to predict profitability for (re)insurance, particularly over the short term. Despite sophisticated risk management techniques - such as reinsurance - that can help to manage volatility through diversification, particularly international spread of risk - (re)insurers are subject to continuing risk and volatility. There are years when (re)insurance companies make significant losses. A single large natural catastrophe or other unexpected event can wipe out several years' earnings.

If insurance were to be included in Pillar 1, this volatility would have to be allocated, which in any given year could be an allocation of significant losses. It is not clear how tax authorities or regulators could be comfortable with a company being allocated such losses.

The volatility is currently borne by the capital provider which, for insurance, Insurance Europe believes is the only feasible and viable recipient.

Identification and measurement issues

The income statement of an insurance group looks very different to a standard trading company and there are accounting changes under IFRS 17 that will make the differences even greater in the future.

While Insurance Europe understands the IF's objectives in looking at taxing rights and nexus in a different way, in an insurance context, Part IV of the OECD's existing PE guidance provides detailed and comprehensive guidance that still holds true. After considerable work over an extended period, it defines and discusses risks, risk management and the allocation of risk and concludes that the key part of the value chain which should be remunerated and have capital attributed in relation to it is the assumption and management of risks.

It is not clear how insurers would identify and calculate routine and non-routine profits for insurance. Neither is it clear how non-routine profits are linked to residual profits, but in an insurance context, residual profits (and losses) are returned to the key entrepreneurial risk-taking ("KERT") function which is the capital provider. These residual profits (and losses) are returned to the capital provider after remunerating other functions (such as brokers or sales agents), as there is simply no other party that bears the insurance losses. As discussed earlier, this is largely in the jurisdiction of the customer.

Moreover, regarding the implementation of the new taxing right (paragraph 41), insurers should not fall in the scope of the new reallocating taxing rights over a proportion of an MNE group's profit. Indeed, source jurisdictions would not reallocate taxing rights to the residence jurisdiction. Therefore, the residence jurisdiction would not provide relief from double taxation of the relevant income.

Other taxes

There are 20 countries across the European Economic Area and other countries, such as Australia and New Zealand, that apply a tax on almost all non-life insurance premiums. Premium taxes are based on the location of risk. For property risks, the risk location is usually where the property is situated. For vehicles, it is usually the physical location of the vehicle or the jurisdiction in which the vehicle is registered. For other risks, the risk location is the territory in which the insured (the customer) is resident or its business establishment is located.

While premium taxes are levied on insureds, the economic costs of premium taxes are important for the whole industry. Tax is already levied in the jurisdiction of the customer or "user" of insurance products. Insurers are also one of the main payers of stamp duties or financial transactions taxes that arise on their asset portfolios. Insurers, other than the countries which apply GST to non-life premiums, also bear rather than collect VAT/GST, whereas most industries are collectors rather than bearers of VAT.

Conclusions on Pillar 1

Insurers are subject to extensive supervisory regulations including the need for specific types of capital in each regulated entity outside the EU. Moreover, residual profits (and losses) are returned to the key entrepreneurial risk-taking ("KERT") function, which is with the capital-providing insurance entity, usually located in the jurisdiction of the customer. Therefore, by design, the taxing rights in the insurance sector are already largely fine-tuned with the jurisdiction of the consumer, so there is no need for the supplementary regulations of Pillar 1.

Insurance Europe is the European insurance and reinsurance federation. Through its 37 member bodies — the national insurance associations — Insurance Europe represents all types of insurance and reinsurance undertakings, eg pan-European companies, monoliners, mutuals and SMEs. Insurance Europe, which is based in Brussels, represents undertakings that account for around 95% of total European premium income. Insurance makes a major contribution to Europe's economic growth and development. European insurers generate premium income of more than €1 300bn, directly employ over 900 000 people and invest over €10 300bn in the economy.