

Draft GFIA response to the OECD Discussion Draft on BEPS Action 4 Approaches to Address BEPS Involving Interest in the Banking and Insurance Sectors

Summary

- GFIA supports the OECD's broad objectives in combating aggressive tax planning through excessive leverage and inappropriate interest deductions. 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 addition, as noted by the OECD in paragraph 6 of the Discussion Draft, any approaches adopted by the OECD "should not conflict with or reduce the effectiveness of regulatory capital rules intended to reduce the risk of a future financial crisis".
- GFIA's recommendations below are consistent with promoting high capital levels to ensure the safety and soundness of financial institutions.
- GFIA welcomes the fact that the OECD recognises in paragraph 26 of the Discussion Draft that "excessive leverage in a bank or insurance company has not been identified as a key risk at this point in time and so it is anticipated that, in the majority of cases, this BEPS risk will be low". The OECD also correctly states that existing regulation acts as a safeguard for any insurance BEPS risk. In addition, other factors restrict excessive leverage in the insurance industry including:
 - financial strength is a critical requirement from a marketing perspective, as consumers look to purchase insurance from sound strong insurers
 - commercial constraints (eg. credit rating agencies) require insurers to hold more than just the minimum required amounts of equity and restrict their ability to hold excessive debt (as the OECD notes in paragraph 5 of the Discussion Draft).
- GFIA therefore recommends that any general rules to address BEPS should apply to insurance groups as a whole (insurance and noninsurance entities combined) without excluding stand-alone insurance companies in that group. Where tax authorities identify specific insurance structures that may require special rules from a BEPS perspective, any such special rules to address those specific structures should be created only after consultation with the industry and should complement the general rules. GFIA believes this would be the most effective way to address any specific issues with insurance structures.
- In the Discussion Draft, the OECD proposes a different solution: a fixed ratio rule which would apply to groups but exclude stand-alone insurance companies from that group. GFIA has strong concerns with this approach because such a calculation of the fixed ratio would exclude the interest income

and operating profit of insurers but would include the full amount of interest expense on debt issued at the holding company level. This would likely lead to an inappropriate interest restriction because, under such a calculation of the EBITDA, the EBITDA of many insurance groups would be negative and most interest would not be deductible.

- Therefore, GFIA believes that this approach is flawed and would unduly affect many insurers that have a non-financial holding company which issues debt and uses the proceeds of the debt to subscribe for equity in the insurance company. The use of equity rather than debt to fund the insurance company is in this case generally a requirement of insurance regulators who prefer the most permanent, loss-absorbing form of capital. As such, it is certainly not a decision which is made by the insurance group for BEPS purposes. Excluding the operating profit of the insurer in applying the fixed ratio rule is clearly inappropriate in such circumstances.
- When the activities of an insurance group consist mainly of insurance-related activities, there are very limited or no earnings in the non-insurance part of that insurance group. This differs significantly from non-financial groups for which the main source of earnings that constitutes the basis for determination of the interest deductibility will be included under the fixed ratio rule. GFIA believes that applying a fixed ratio rule to the non-insurance part of an insurance group only (or separately) is not appropriate.
- The OECD recognizes that non-deductibility of interest may not be appropriate in the case of instruments that support regulated banking or insurance activities. The OECD proposes a way to address this in paragraph 56 which is only partially effective because, while it provides in principle an exclusion for third party interest on regulatory capital, it still includes other third party interest. Including non regulatory debt within the scope of the rules could result in inappropriate interest restrictions even where an insurance group is not excessively leveraged.
- Finally, GFIA strongly recommends that insurers' existing debt should be excluded entirely or at least benefit from a transitional period for the remaining term of the debt to allow for the most efficient restructuring of the debt, a big part of which is long-term debt that cannot be repaid or renegotiated before the end of that remaining term without cost or penalty.

Answers to consultation questions

1. ***Are there any categories of BEPS risk involving interest posed by banks or insurance companies, or entities in a group with a bank or insurance company, not identified in the discussion draft which should be focused on as part of this work? If so, what are these risks and how could they be addressed (either through the approaches set out in this discussion draft or otherwise)?***
3. ***Are there other any general issues related to the impact of regulatory capital rules on the level of leverage in a bank or insurance company that should be taken into account? It should be clearly identified where these are issues relevant to all or a large number of countries or where they concern a particular country's regime.***

In all jurisdictions, insurers are subject to prudential regulation which acts as a safeguard for any insurance BEPS risk. In Europe, this is Solvency II and in other major jurisdictions, this refers to frameworks which are Solvency II equivalent. Such frameworks cap the amount of debt an insurer can hold to meet its regulatory capital requirements while also providing adequate safeguards to prevent or significantly minimize any BEPS activity.

5. Are there any concerns raised by a country not introducing tax rules to deal with excessive interest deductions in banks and/or insurance companies including permanent establishments, if the country has established that no material BEPS risk exists (which may be as a result of the operation of regulatory capital rules)?

GFIA recommends that general rules to address BEPS should apply to insurance groups as a whole (insurance and noninsurance entities combined) without excluding stand-alone insurance companies in that group. Where tax authorities identify specific insurance structures that may require special rules from a BEPS perspective, any such special rules should be created only after consultation with the industry and should complement the general rules. GFIA believe this would be the most effective way to address any specific issues with insurance structures.

7. Are there any other practical considerations related to the application of the fixed ratio rule to banks or insurance companies that should be taken into account?

The OECD proposes a fixed ratio rule which would apply to groups but would exclude any stand-alone insurance companies in that group. GFIA has strong concerns with this approach, because such a calculation of the fixed ratio would exclude the interest income and operating profit of insurers but would include the full amount of interest expense on debt issued at the holding company level. This would likely lead to an inappropriate interest restriction because under such a calculation of the EBITDA, the EBITDA of many insurance groups would be negative and most interest would not be deductible.

Therefore, GFIA believes that this approach is flawed and would unduly affect many insurers that have a non-financial holding company which issues regulated debt and uses the proceeds of the debt to subscribe for equity in the insurance company. The use of equity rather than debt to fund the insurance company is in this case generally a requirement of insurance regulators who prefer the most permanent loss-absorbing form of capital. As such, it is certainly not a decision which is made by the insurance group for BEPS purposes. Excluding the operating profit of the insurer in applying the fixed ratio rule is clearly inappropriate in such circumstances.

When the activities of an insurance group consist mainly of insurance-related activities, there are very limited or no earnings in the non-insurance part of that insurance group. This differs significantly from non-financial groups for which the main source of earnings that constitute the basis for determination of the interest deductibility will be included under the fixed ratio rule. GFIA believes that applying a fixed ratio rule to the non-insurance part of an insurance group only (or separately) is not appropriate.

The OECD recognizes that non-deductibility of interest may not be appropriate in the case of instruments that support regulated banking or insurance activities. The OECD proposes a way to address this in paragraph 56 which is only partially effective because, while it provides in principle an exclusion for third party interest on regulatory capital, it still includes some third party interest.

8. Are there any other considerations with respect to the ability of banks and insurance companies to use interest to fund non-taxable income on an equity investment that should be taken into account?

Many insurers have a non-financial holding company which issues regulated and/or general debt and uses the proceeds of the debt to subscribe for equity in the insurance subsidiary. The use of equity rather than debt to fund the insurance subsidiary is in this case a requirement of insurance regulators who prefer the most permanent loss-absorbing form of capital. As such, it is certainly not a decision which is made by the insurance group for BEPS purposes as demonstrated by the fact that insurance groups are not excessively leveraged.

13. Are there any additional practical issues arising from the modifications to the fixed ratio rule described in the discussion draft, as it applies to an entity in a group with a bank or insurance company:

- a. application of the fixed ratio rule to the local group excluding banks and insurance companies.** GFIA has strong concerns with the OECD's proposed fixed ratio rule which would apply to groups excluding stand-alone insurance companies in that group. In this situation, the majority of income and business profits would effectively be removed from the interest limitation rules while leaving the full amount of interest expense on debt issued at the holding company level within the scope of the restriction calculation, which would result in inappropriate interest restrictions. GFIA has similar concerns with the suggestion to create a second local group containing only insurance subsidiaries and to apply the fixed ratio rule to that group.
- b. the treatment of interest expense on debt supporting banking or insurance activities.** The OECD recognizes that non-deductibility of interest may not be appropriate in the case of instruments that support regulated banking or insurance activities. However, GFIA has concerns as explained above with the OECD's proposal to address this issue through the fixed ratio rule as it may lead to inappropriate interest restrictions. As we recommend above, we believe the general rules should be applied to an insurance group as a whole.

15. Are there any additional practical issues arising from the approaches for applying the group ratio rule to an entity in a group with a bank or insurance company that should be taken into account?

16. Are there any other approaches to applying the group ratio rule to an entity in a group with a bank or insurance company that should be considered?

In GFIA's view, applying the group ratio rule to an insurance group while excluding insurance subsidiaries would result in similar concerns as when the fixed ratio rule is applied: it would exclude the interest income and operating profit of insurers but would include the full amount of interest expense on debt issued at the holding company level. This would likely lead to an inappropriate interest restriction because, under such a calculation of EBITDA, the EBITDA of many insurance groups would be negative and most interest would not be deductible.

17. Do you have any other comments on any of the issues raised by this discussion draft?

GFIA recommends that insurers' existing debt should be excluded entirely since most of it is long-term debt and it would be very difficult and costly to repay or restructure it before the end of its remaining term. In the event that insurers' existing debt is not entirely excluded, then, at the very minimum, it should benefit from a transitional period for the remaining term during which it cannot be repaid or restructured without cost or penalty to allow for the most efficient debt restructuring.

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About GFIA

Through its 41 member associations, the Global Federation of Insurance Associations (GFIA) represents the interests of insurers and reinsurers in 60 countries. These companies account for around 87% of total insurance premiums worldwide. GFIA is incorporated in Switzerland and its secretariat is based in Brussels.