2 September 2022

Assistant Secretary
Corporate and International Tax Division
The Treasury
Langton Crescent
PARKES ACT 2600

Submitted by email: MNETaxIntegrity@treasury.gov.au

Insurance Australia Group Limited (**IAG**) is pleased to provide a response to the Treasury on *Government election commitments: Multinational Tax Integrity and Enhanced Tax Transparency* (**Consultation Paper**) issued in August 2022. Please note that we have not attempted to answer all the questions in the Consultation Paper but rather provide targeted comments relating to the MNE interest limitation rules.

IAG is the parent company of a general insurance group with controlled operations in Australia and New Zealand. Our businesses underwrite almost $12 billion of premium per annum, selling insurance under many leading brands, including: NRMA Insurance, CGU, SGIO, SGIC and WFI (in Australia); and NZI, State, AMI, and Lumley Insurance (in New Zealand). With more than 8.5 million customers and information on the majority of domestic residences in our markets, we use our leadership position to understand and provide world-leading customer experiences, making communities safer and more resilient for the future.

Our purpose is to make your world a safer place and we recognise that our role extends beyond transferring risk and paying claims. Our purpose drives our business to work collaboratively with the community to understand, reduce and avoid risk, and to build resilience and preparedness. This results in better outcomes for the community and means fewer claims and lower costs for our business.

We work collaboratively with government, industry bodies and Australian and international organisations on a range of topics and issues that relate to our customers, our people and the community including safety on the road.

Our response

MNE interest limitation rules

IAG supports the objectives announced by the Government to address tax avoidance practices of multinationals (**MNE**) including amending Australia's existing thin capitalisation rules to limit interest deductions for MNEs. We note the Government's objectives are in line with the Organisation for Economic Cooperation and Development's (**OECD**) recommended approach under Action 4 of the Base Erosion and Profit Shifting (**BEPS)** program as outlined in the Consultation Paper. IAG's response is in accordance with the recommended approach for insurers set down in the OECD's Action 4.

While IAG is supportive of the proposed measures, consistent with the language in the Consultation Paper and the OECD's Action 4 paper,[1] we strongly recommend that an exemption from the fixed ratio rule be provided to APRA-regulated insurance groups such as IAG.

Specifically, the Consultation Paper acknowledges that the fixed ratio is inappropriate for financial entities and authorised deposit-taking institutions partly because the entities are:

- Net lenders; and
- Are subject to regulatory capital rules.

The commentary in the OECD's Action 4 paper expands on why the fixed ratio rule is not appropriate for banking and insurance entities as follows:

- *"Although banks and insurance companies are engaged in very different businesses, in both cases third party interest income is vitally important to ensure a group's profitability and liquidity. For insurance companies, interest income is a major form of investment income used to meet insurance liabilities as they fall due. In both cases, the nature of interest is fundamentally different to that for most other businesses, where interest income is linked to the treasury function of managing a group's net debt.*
- *Banks and insurance companies are subject to regulatory capital rules and commercial constraints (e.g. from credit rating agencies) which require them to hold minimum amounts of equity and restrict their ability to place an excessive level of debt in particular entities or to use debt to fund equity investments in subsidiaries.*
- *Banks and insurance companies are key providers of debt finance to groups in other sectors, either as lenders or as investors in corporate bonds. As such, entities engaged in banking or insurance business will typically have net interest income rather than net interest expense."*[2]

We would also draw your attention to the OECD's acknowledgement in the Action 4 paper, that "*significant regulatory and commercial considerations reduce the risks posed by a banking and insurance groups*"[3] and that excessive interest deductions are claimed such that "*it is not expected that [a] country should introduce new rules to deal with a risk that does not exist or is already addressed*"[4]. Instead, the OECD suggests *"[i]n this case, a country may reasonably exempt banking and/or insurance groups from the fixed ratio rule and group ratio rule without the need for additional tax rules*".[5]

---

[1] Limiting Base Erosion Involving Interest Deductions and Other Financial Payments, Action 4 – 2016 Update, 22 December 2016 (**the Action 4 Paper**)

[2] The Action 4 Paper, paragraph 487

[3] The Action 4 Paper, Executive Summary, pg 14 - 15

[4] The Action 4 Paper, paragraph 484

[5] Ibid

Set out below is an overview of how a general insurance group, such as IAG, should not give rise to a material risk of excessive interest deductions as a result of how:

- Net interest is recognised;
- Capital and debt issued is regulated by APRA; and
- Finance is provided to the market.

We have also highlighted particular concerns we have in relation to the application of the fixed ratio rule.

APRA Regulation

Insurers play a unique role in the economy, protecting individuals and businesses from financial loss arising from risks ranging from natural catastrophes, workplace injuries and the inability to work because of illness or injury. The essence of insurance is the transfer or risk between the insured party and the insurance company in exchange for the payment of premium. It is for this reason that regulated insurance groups, such as IAG, are subject to strict regulatory capital rules which limit the ability to excessively gear their operations by requiring them to hold minimum amounts of equity. This ensures that insurance groups will be able to pay any claims that arise beyond those expected and ultimately that policyholders are protected.

The OECD acknowledge that "*[i]n most cases it is expected that regulatory capital rules will be effective in protecting countries from excessive interest deductions in a solo-regulated bank or insurance company.*"[6]

Specifically, the regulatory capital rules should be effective at reducing excessive interest deductions if APRA ensures that an *"…insurance company is capitalised with an appropriate level of equity, where the definition of equity for tax and regulatory purposes is consistent, these rules may also provide protection against excessive leverage for tax purposes".*[7]

The effect of this is that APRA regulation acts like an effective interest limitation rule for insurance groups and given the greater proportion of equity capital in relation to debt for insurance groups when compared to other industries, we believe that APRA's regulatory capital rules will be effective in protecting Australia from excessive interest deductions from general insurers i.e. insurance groups would pose little BEPS risk in relation to Action 4.

As highlighted in the Consultation Paper, the fixed ratio rule will target 'general entities' as defined under the current thin capitalisation legislation. Financial entities and authorised deposit-taking institutions are effectively exempted and can continue to be subject to the existing thin capitalisation rules. Given banking groups will either be authorised deposit-taking institutions or financial entities and are subject to similar APRA regulatory capital rules applicable to insurance groups, we strongly believe that it would be reasonable to also exempt the fixed ratio rule for insurance groups.

[6] The Action 4 Paper, paragraph 481

[7] The Action 4 Paper, paragraph 487

Net interest expense

General insurers typically have net interest income (by virtue of investing premium income received into debt finance products issued by corporates and the Federal Government). In this scenario the fixed ratio rule in the Action 4 paper is unlikely to provide protection against the risks of excessive interest deductions such that there would be no net loss to revenue if general insurance entities were excluded from the measure (noting the role APRA regulation plays in ensuring excessive interest deductions cannot also be claimed – refer above).

In the event that general insurers are not excluded, there may be instances where a general insurer would experience net interest expense rather than net interest income by virtue of the way in which debt assets are held. It is not uncommon for general insurers to invest into a unit trust which holds debt assets (**Investment Trust**). The general insurer would bring to account the net income of the Investment Trust which includes gains and losses from the sale of debt assets as well as the interest income derived.

Where the Investment Trust disposes of underlying debt assets for a loss that is in excess of the interest income derived, those losses will not be distributed to the general insurer. This has occurred in the past and may happen in the future. As a result, the gross interest income derived is also **not** distributed to the general insurer. Where this occurs, the fixed ratio would likely be in a net interest expense position giving rise to interest denial after the application of the fixed ratio rule.

To ensure that general insurers that invest a significant amount of premium income through investment trusts are not disadvantaged compared to those entities who invest directly into debt assets, the calculation of gross income for the fixed ratio should include the gross interest from the underlying Investment Trusts.

To continue to support the financing of businesses and the Federal Government, it is suggested that APRA-regulated general insurers should be excluded from the fixed ratio rule.

Interest denial and increased compliance costs may increase the cost of insurance

Given the fixed ratio rule is based on EBITDA, insurers who typically experience substantial volatility in profitability due to the nature of insurance may result in interest denial or may look to explore and incur significant costs in applying one of the alternative tests (such as the worldwide gearing test and arm's length debt test) which they currently are not required to apply under the existing thin capitalisation rules.

Even if the Government was to introduce a carry forward of disallowed interest to be utilised in future years this is likely to increase the cost of capital to IAG as Deferred Tax Assets (**DTAs**) are subtracted from the regulatory capital base of insurance companies (notwithstanding that the differences are temporary in nature).

The scenarios noted above may result in additional costs for IAG that would be passed onto policyholders by way of an increase in insurance premiums.

The Consultation Process

We thank the Treasury for initiating this consultation process. We understand that further consultation will be undertaken on the exposure draft legislation before its introduction into Parliament.

Should the Government decide as a matter of policy to introduce the fixed ratio rule for insurance groups such as IAG, we would appreciate a meeting with the Treasury prior to the release of the exposure draft legislation to discuss any options to ensure there are no unintended tax consequences arising for insurance groups such as IAG.

We look forward to working closely with the Treasury in its review and future consultations.

If you have any questions or require any further information, please do not hesitate to contact Sarah Pang on 0401 683 705.

Yours sincerely

Paul Baker
Executive General Manager, Head of Tax