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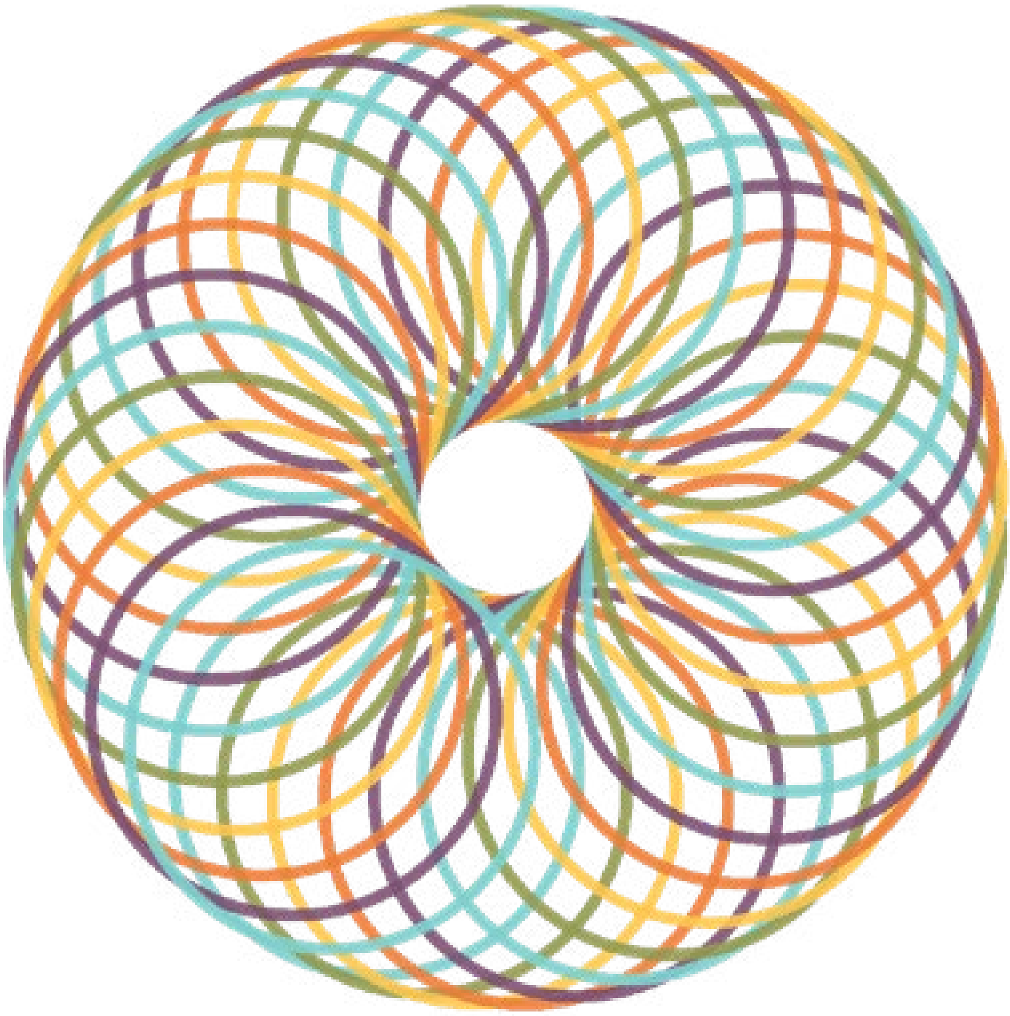

Captive insurance companies of non-insurance groups – key transfer pricing considerations

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Why now?

The revised OECD Transfer Pricing Guidelines issued in July 2017 included an example on captives, and in July 2018, the OECD issued a Public Discussion Draft with respect to Financial Transactions which included a section on captive insurance. In February 2020, a final version of this report, "Transfer Pricing Guidance on Financial Transactions" was released, which continued to include material on captives and will form a new section of the OECD Guidelines. Concurrently, there has been an increasing number of tax audits of captives and, in some countries, these have resulted in the matter being referred to the courts.

With this in mind, this article is focused on two particular areas; the February 2020 OECD material on captives as well as recent US case law on "abusive" micro-captives.

What is a captive insurance company?

But first, what is a captive insurance company ("captive")? A captive is an insurance company created and wholly owned by a non-insurance group to underwrite risks for the operating subsidiaries and / or the parent company itself. In general, captive insurers:

- Put their own capital at risk;
- Work outside the traditional commercial insurance market, instead forming part of the alternative risk transfer ("ART") market; and
- Are subject to regulatory, actuarial, accounting and capital requirements.

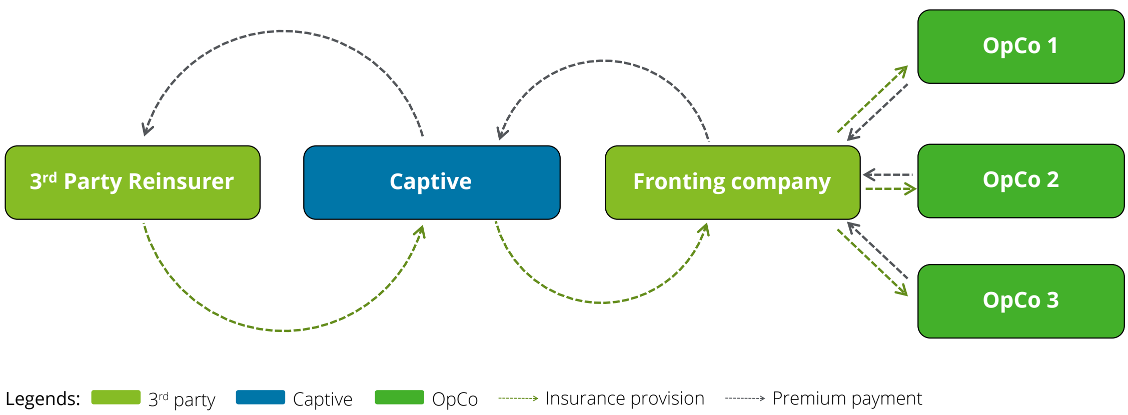
The diagram below sets out one type of captive structure and the flow of transactions for a captive:

- Each operating company ("OpCo") enters into an insurance transaction with a third-party fronting company for regulatory reasons. In turn, the fronting company places the risk with a Group captive. For transfer pricing purposes, even though a third party entity is involved in the chain, tax authorities could view the actual controlled transaction as between the OpCo and the captive.
- The captive retains the risk, or a proportion of the risk and seeks external reinsurance with a third / unrelated party for certain layers or proportions of the risks.

Captives can provide a number of key commercial benefits to multinational enterprise ("MNE") groups. They can provide coverage for risks that may be difficult or impossible to obtain in the open market due to, for example, the "low frequency" and "high severity" nature of the risk (e.g. oil spills, contingency business interruption, product liability risk, etc.). They can reduce volatility in the profits at the OpCo level by ring fencing assets to pay claims rather than the OpCo bearing the full economic effect of covered losses. They can stabilise premiums paid by group members within the multinational group, and they can help the group obtain lower premiums in third party insurance/reinsurance markets as a result of pooling of risks in the captive and "bulk discounts".

Captive insurance: Section F of the OECD's new guidance on financial transactions

The OECD's new guidance covers background on captives, the commercial rationale for captive insurance / reinsurance arrangements, accurate delineation of the transaction, and pricing methods and issues. This article focuses on the last two matters as these are likely to be of most interest to taxpayers.



Accurate delineation of transaction: A genuine insurance transaction?

A significant emphasis of the new guidance is on accurate delineation of the transaction. According to the guidance, this effectively means assessing whether the behaviour of the parties are aligned with the written terms of the legal contract. Per paragraph 10.199 of the guidance, in order for the transaction to be delineated as a genuine transaction of insurance, the following criteria must be met:

- There is diversification and pooling of risk in the captive insurance;
- The economic capital position of the entities within the MNE group has improved as a result of diversification and there is therefore a real economic impact for the MNE group as a whole;
- Both the captive insurance and any reinsurer are regulated entities with broadly similar regulatory regimes and regulators that require evidence of risk assumption and appropriate capital levels;
- The insured risk would otherwise be insurable outside the MNE group;
- The captive has the requisite skills, including investment skills, and experience at its disposal;
- The captive has a real possibility of suffering losses.

Whilst many of these criteria should be met by the majority of captives, two in particular stand out as potentially being at odds with some captive arrangements.

The first challenge is around diversification. The guidance stresses that this is key, as this is how third party insurance companies are able to be profitable; this harkens back to the seminal insurance industry concept of the contributions of the many (premiums) covering the losses of the few and the operation of the "law of large numbers" to fairly accurately model expected losses. Third party insurance companies can quite easily achieve this through line of business (e.g. property versus liability) and geographic diversification. Even monoline insurers such as motor insurers can achieve diversification through factors such as geography and types of drivers and vehicles. For a captive insuring risks emanating only from one MNE, however, this can be more difficult, unless the MNE is a conglomerate. Pharmaceutical companies may, for example, be most focused on insuring product liability risk in particular jurisdictions (e.g. the US), whereas a mining group might be concerned with business interruption risk.

The second challenge is around whether the insured risk would otherwise be insurable outside the group. Captive insurance companies exist in some instances precisely to insure risks that for all practical and commercial purposes are not insurable externally, whether because of cost, or on account of the challenges and administrative hurdles (e.g. extensive documentation required) associated with insuring unique or special risks with third parties. It may nevertheless be commercially rational and in the best interests of the insured to purchase captive insurance coverage for risks that are not insurable externally—which is explicitly acknowledged by the OECD in paragraph 10.194 of the new guidance in the February 2020 report. Therefore, this criterion is at odds with paragraph 1.122 of the OECD Guidelines on non-recognition, which states that "Importantly, the mere fact that the transaction may not be seen between independent parties does not mean that it should not be recognised" and that only transactions that are not commercially rational should be disregarded. In this instance, tax authorities could use the new guidance not to disregard a captive insurance transaction in full, as the non-recognition criteria are not met, but rather to re-price the transaction as something other than insurance (e.g. provision of funding) under the principles of accurate delineation.

The new OECD guidance also briefly touch on substance requirements, which fall under accurate delineation of insurance as well. In essence, the new concepts of "control over risk" and "financial capacity" in order to perform a proper risk allocation, based on actual conduct rather than on contractual relationships, fully apply to captives. In particular, in situations in which part of the underwriting function is outsourced to a third party service provider special consideration should be given to the retention of control functions. In this respect, the competency (educational background and professional experience) of the employed staff of the captive as well as the level of information available to it needs to be sufficient to exercise such control activities.

It remains to be seen how tax authorities will interpret and apply the new rules in practice; that is, whether they treat each of the six criteria listed above as absolutely required to delineate the transaction as one of insurance, or whether achieving a majority of the six criteria is sufficient to qualify as insurance. Regardless, taxpayers should prepare and maintain evidenced transfer pricing documentation considering each of the above six criteria based on the facts and circumstances of the captive in question.

OECD Transfer Pricing approaches

The new OECD guidance also sets out which of the transfer pricing methods may be appropriate to use for captive insurance transactions, including the comparable uncontrolled price method ("CUP") as well as the transactional net margin method ("TNMM") where the profit level indicators ("PLI") are combined ratio and return on capital, benchmarked by reference to third party insurance/reinsurance companies. However, the quality of these types of comparables vis-à-vis captive insurance may be in question, given the likely higher level of diversification in third party carriers compared to a captive. Furthermore, independent insurers/reinsurers may have an incentive to hold additional capital (the denominator in the return on capital calculation) over and above regulatory requirements given that additional capital can provide a third party insurer/reinsurer with a rating benefit from third party rating agencies such as A.M. Best. Captives generally have no such incentive to hold additional capital.

The guidance also covers the concept of "group synergies" where the captive is used as a pooling vehicle to access the reinsurance market, e.g. by achieving economies of scale or by negotiating a bulk discount on premiums with a third party reinsurer, such that the reinsurer accepts a lower premium as a result of a larger, more diversified pool of risks in a captive. In this instance, the guidance stresses that any such benefit should be passed on to the insured OpCos in the form of discounted premiums, and not retained in the captive. However, what is not considered here is that the captive should still be due some remuneration for whatever activities it performs in line with basic transfer pricing principles, based on the functional analysis. For example, do personnel in the captive negotiate the discounted premiums with the third party reinsurers, such that this is an activity that should be compensated for, even if only on a cost plus basis?

Given the challenges inherent to the above approaches, captive owners may wish to consider also performing an independent actuarial analysis of premiums paid to the captive, assessing the reasonableness of key assumptions and parameters (e.g. claims history and expense loadings) to determine whether these assumptions and parameters are in line with the methodologies (e.g. 'severity' and 'frequency' loss curves) used to price insurance premiums in the third party market. This is an application of an "other" transfer pricing method under the OECD Guidelines.

Conclusion: Important questions for captives from an OECD perspective

For MNEs with captives, bearing the new OECD guidance in mind, the following should be considered, evidenced, and documented:

- Is the transaction in question one of insurance?
- What is the commercial rationale for the controlled transaction?
- Does the captive have the functional capability to manage the risks ceded to it, e.g. does it employ staff with relevant actuarial and underwriting experience?
- Does the captive have the capital to assume the risks ceded to it?
- Would the controlled transaction have been agreed to between unrelated parties under comparable economic circumstances?
- Is the premium priced on an arm's length basis and how is this supported?
- Is there supporting documentation with regard to the negotiation process and transfer pricing position?

Other tax considerations

Alongside the transfer pricing treatment of captives, there are other direct tax considerations such as tax residence and permanent establishment risks resulting from remote decision-making. For example, for groups with risk management functions based outside the jurisdiction of the captive. The delineation of buy-side and sell-side activities in respect of the insurance for personnel with dual roles is key such that effective decision making relating to the captive takes place in the jurisdiction of the captive.

Targeted measures, such as the UK's diverted profits tax ("DPT") which seeks to tax profits artificially diverted from the UK at a punitive rate, have also prompted enquiries into captive arrangements where the captive is based in a low tax jurisdiction. In line with the new OECD guidance on determining whether a captive arrangement is a genuine insurance transaction, it is important to be able to explain to the tax authorities why the captive is used, covering both the original set-up and its continued use. HMRC's DPT guidance contains an example of a captive insurance arrangement where there are no commercial motives for the transaction other than the tax saving, concluding that a DPT charge should arise.

Controlled foreign company ("CFC") rules have also now been widely implemented across the European Union as a result of the EU's Anti-Tax Avoidance Directive. The application of CFC rules both in the EU, and more widely, to the activities of the captive should be considered.

U.S. perspective

The application of U.S. captive tax principles may provide context for captive developments in the OECD and provide live examples of how a tax authority is engaging with some captive insurance arrangements.

Specifically, captive insurance arrangements have been subject to particular scrutiny by the IRS in recent years and there have been captive tax court cases decided in favour of the IRS. Given this backdrop, a U.S. update is provided below.

LB&I Captive Services Provider Campaign

In April 2019, the IRS announced a compliance campaign focused on the pricing of intercompany arrangements with captive service providers, including insurance coverage issued by foreign captive insurance companies. The release largely indicates that U.S. transfer pricing regulations under section 482 and the OECD Transfer Pricing Guidelines provide guidance for ensuring arm's-length pricing of services between affiliates, whereby:

"arm's length price [should be] determined by taking into consideration data available on companies performing functions, employing assets, and assuming risks that are comparable to those of the captive subsidiary."

The stated goal of the compliance campaign is to ensure that U.S. multinational companies pay their foreign captive service providers (including captive insurance companies) no more than arm's-length prices in order to prevent erosion of the U.S. tax base. Furthermore, in February 2020, the IRS announced it has established 12 new teams to audit what it has deemed to be "abusive" micro-captives. A micro-captive is a captive that takes in no more than $2.2 million in annual premiums and have elected under Internal Revenue Code section 831(b) to be taxed only on investment income (but not underwriting income).

U.S. Case Law Update

Recently, the IRS has challenged a number of captive insurance arrangements in court with favourable outcomes for the IRS. The most recent U.S. Tax Court opinion was issued in April 2019 in the case of Syzygy Insurance Co. Inc., v Commissioner,117 T.C.M. 1165 (10 April 2019), where the Tax Court held that the coverage provided to S-corporation affiliates through a fronting arrangement by Syzygy, a captive company domiciled in Delaware, did not constitute insurance for federal income tax purposes.

The Court's analysis considered all relevant facts and circumstances, and focused on the four common law criteria that must be met for an arrangement to constitute "insurance":

01. Insurable risk;

02. Risk transfer/risk shifting from the insured to the insurance company;

03. Risk distribution among the insureds; and

04. Commonly accepted notions of insurance.

It is worth flagging that these four criteria overlap with the OECD's requirements for a transaction to be accurately delineated as one of insurance.

The Court held that Syzygy did not qualify as an insurance company, making it ineligible to make a section 831(b) election to exclude its underwriting income from taxable income. The Court's analysis specifically touched on the last two criteria: (i) risk distribution among insureds and (ii) insurance in the "commonly accepted" sense. These are considered below.

Distribution of Risk

The Court noted the fronting arrangement was not actuarially validated and lacked terms and rates that an arm's-length buyer would require. As such, the Tax Court found that the fronting arrangement did not constitute bona fide insurance. In light of this finding, the Court held that the arrangement did not achieve risk distribution under the common law test.

Insurance in its commonly accepted sense

In analysing whether the arrangement was insurance in its commonly accepted sense, the Court identified a number of unfavourable facts pertaining to this common law criteria, including: no claims were made although multiple claims could have been made, Syzygy had no established claims management process, more than 50 percent of the asset value in the captive consisted of interests in two life insurance policies that had ambiguous contractual terms, and premiums were unreasonably high.

Therefore, the Tax Court found that while Syzygy was adequately capitalised the arrangement was not insurance in its commonly accepted sense.

While the Court's opinion did not specifically address (1) presence of insurable risk, and (2) risk transfer/risk shifting, it ultimately both disallowed the deduction for premiums paid by the related party insureds and required Syzygy to include the insurance premiums in taxable income.

The decision in this case extends the run of Tax Court opinions unfavourable to certain types of captives, following Avrahami v. Commissioner,149 T.C. 144 (2017) (section 831(b) "micro-captive") and Reserve Mech. Corp. v. Commissioner,115 T.C. M. 1475 (18 June 2018)(section 501(c)(15) tax exempt captive). This is also the first case in which the IRS both denied the purported insured's deduction for insurance premiums and the captive was required to include the "premium" income in its taxable income.

U.S. Takeaways: The Captive Environment

The decision in Syzygy and the announcement of the LB&I transfer pricing campaign for captive services, taken together with other developments, including designation by the IRS of certain section 831(b) captives as a "Dirty Dozen" tax scam, the other Tax Court decisions noted above, and required information reporting as a "transaction of interest" as prescribed in Notice 2016-66, evidence a trend of substantial increased scrutiny of captive insurance companies by the IRS and disapproval of certain captive insurance arrangements, based on all the facts and circumstances of each captive, by U.S. Tax Court.

These recent developments highlight the importance of preparing premium pricing and risk transfer (FAS 113-type) analyses for all material captive transactions; this analysis should be completed by an independent and reputable actuarial firm. The reasonableness of the calculations should be closely reviewed. In addition, risk transfer testing associated with the captive transactions ought to be completed and documented contemporaneously, particularly for transactions involving loss portfolio transfers (i.e., a financial reinsurance transaction in which loss obligations that are already incurred and will ultimately be paid are ceded to a reinsurer.)

In all captive cases, complete and accurate tax documentation of an entity's qualification as an insurance company under the relevant local country rules and appropriate pricing of insurance premiums paid to a captive are essential self-defence mechanisms for MNEs and should go a long way in the event of an audit by the taxing authority.

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