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Transfer Pricing: Accurate Delineation of the Captive Insurance Arrangement – Is the OECD Guidance Clear on this Matter?

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Introduction

Recently captive insurance arrangements have been scrutinized all over the world by tax authorities as they are believed to be vehicles that encourage profit shifting. The OECD, in the BEPS Action Plan, had considered captive insurance arrangements as a major area of concern. In fact, in the recently released 2018 OECD discussion draft on financial transactions (discussion draft), the OECD attempts to provide guidance on transfer pricing aspects of captive insurance arrangements. One key concern for captive owners in the new transfer pricing environment is the recognition of the arrangement. The contribution explores this concern in light of the 2017 transfer pricing guidelines (guidelines) and the discussion draft. It should be noted that a discussion on arm's length pricing of insurance related transactions is beyond the scope of this contribution.

Captive (re)insurance and its commercial rationale

Individuals and corporates buy insurance cover for risks such as life and health, motor and home, business and catastrophes with so-called direct insurers. These grant cover and in turn the insureds pay a premium. Direct insurers may pass on part of their insurance risk to reinsurance companies (so-called cession), who again may pass on ("retrocede") their risks to other reinsurers. To ensure insurers or reinsurers will be able to pay claims even under adverse conditions, the industry is heavily regulated, with regulators demanding a minimum amount of capital plus a security margin, for instance, under the commonly accepted Solvency II framework in the European Union.

Captive insurance is a special form of intra-group insurance or reinsurance within a multinational group. The common feature across the multitude of existing definitions is that the captive insurance or reinsurance entity is owned (wholly or partly) by the insureds and the aim of the captive is (completely or partly) to cover insurance needs of their owners. A direct captive insurance entity issues insurance policies to the operating entities of its group. In contrast, a reinsurance captive underwrites insurance risk of the group by partnering with a commercial third-party insurer, the so-called “fronter”. The fronter issues the local insurance policies to the operating entities, and then retrocedes part of the risk to the reinsurance captive entity.

Taxpayers often cite the optimization of total cost of risk within a multinational group as a commercial reason for captive arrangements. Moreover, multinational groups may want to obtain insurance cover for risks traditionally over-priced or not readily available or take advantage of the more favorable reinsurance market. Their negotiating power towards traditional (re)insurers increases due to risk bundling by virtue of higher volumes. The captive offers insurance deductibles and provides coverage according to the individual risk profiles of the local entities, consolidates them and seeks insurance cover on this level, rather than every local entity negotiating with external insurers. Insurance market volatility and capacity can also be mitigated. Mutualizing risks within a multinational group will help smoothen local volatility and hence capital costs. Another strategic goal for captives may be risk pooling to financially protect operational entities to a level that they can tolerate and withstand.

Is the transaction an insurance transaction?

At the outset, a question arises as to whether the premium payment made to the captive can be claimed as a deduction? The judiciary in the US, in comparison to other jurisdictions, has decided the issue on numerous occasions and has held that an expense claim can only be made when the arrangement qualifies as *insurance*. The US Supreme Court, in the seminal *Le Gierse judgment*, held that insurance generally involves *risk shifting* and *risk distribution*. Since then, the US Courts have held that the following four criteria should be present in an arrangement to determine if it constitutes insurance: (i) the arrangement should provide for insurable risks; (ii) the arrangement must shift the risk of loss from the insured to the insurer; (iii) the insurer should distribute the risks among its policy holders; and (iv) the arrangement must constitute insurance in the commonly accepted sense. For instance, see the judgments pronounced by the US Tax Courts in the *2014 Securitas Holdings* and the *2017 Avrahami* cases.

The OECD, in its discussion draft (*Para 166* and *Paras 174-176*), also alludes to these factors, in particular, *risk shifting* and *risk distribution*. While the concept of risk distribution is decently explained, the guidance on *risk shifting* is rather generic.

With respect to *risk shifting* it should be noted that the US tax administration, by relying on the economic family doctrine, have tried to argue that risk shifting does not occur in a multinational group context, as it amounts to self-insurance. However, US Courts have not accepted this argument and have subsequently developed a balance sheet and net worth analysis test to ascertain the economic consequences of the captive insurance arrangement. Essentially, the tests look at the insured’s assets to understand whether the insured has “*divested itself of the adverse economic consequences”* of a claim covered by the insurance policy.

Typically, in parent-subsidiary arrangements (captive providing insurance to its parent), the Courts have denied a deduction of the insurance premium, as it is argued that the parent bears the economic loss of the captive insurance arrangement. This is because, when a parent suffers an insured loss that its captive subsidiary has to pay, the assets of the captive will be reduced by the amount of payment, thereby reducing the value of the captive's shares held by the parent as an asset. The depletion in the value of the shares held in the captive affects the balance sheet and net worth of the insured, i.e. the parent. For example, see the discussion of the US Court of Appeals, Ninth Circuit in the *Carnation Company* and *Clougherty Packing Co* cases. Nevertheless, if the captive has sufficient third-party risks, the insurance payments may be allowed as a deduction even if the deduction of the payment would be denied under the balance sheet test. This is because, based on the law of large numbers, risks are considered to be shifted from the insured to the captive. For example, see the verdict of the US Court of Appeals, Ninth Circuit in the *Amerco case*.

On the other hand, in brother-sister arrangements (captive providing insurance to the members of the multinational group that do not have any ownership interest in it), the Courts have allowed a deduction of the insurance expense to the extent that the captive is not a sham. In such arrangements, the payments by the captive on insured losses do not impact the balance sheet and net worth of the insured, as the latter do not have any ownership interests in the former. Accordingly, a deduction of the insurance premium is allowed as long as the captive is formed for a valid business purpose; it is a separate, independent and viable entity; it is financially capable of meeting its obligations; and it reimburses the insured losses when the claim arises. For example, see the verdict of the US Court of Appeals, Sixth Circuit in the *Humana* case.

Accordingly, it would be advisable if the OECD could provide further guidance on the concept of risk shifting and its application to parent-subsidiary and brother-sister relationships.

Delineating the captive arrangement

Allocation of risks and returns to the captive entity

As a principle, the remuneration of an entity should follow its functional profile (functions performed, assets employed and risks assumed). If the functional profile indicates that the captive, which has received regulatory approvals to act as an insurer/reinsurer, acts as a service provider then that captive should be entitled to a lower remuneration. This would typically be a service fee in the form of a cost-plus remuneration. For instance, such an approach was followed by the Dutch Courts in the *Dutch Holiday resort* and *Dutch reinsurance* cases. A similar approach is also outlined in the updated *Transfer Pricing decree* issued by the Dutch Ministry of Finance (*section 10*) as well as the discussion draft (*Paras 184-185*) in the context of captives that only pool risks.

The question then arises as to under which situations can the captive be entitled to its core income i.e. insurance and investment related returns? The OECD also requested an answer to this question in the discussion draft (*Box E.1*). In our opinion, the captive should be entitled to such core income when it employs appropriate personnel (such as underwriters or investment specialists) and these personnel's functions demonstrate that they have the capability to make decisions with respect to (i) taking on, laying off or declining the insurance or investment risk; and (ii) deciding whether and how to respond to the insurance or investment risk associated with the decisions making opportunity. Moreover, the entity also demonstrates that it can perform the decision-making activity associated with the risks. Furthermore, even if the management of risks is outsourced, the personnel in the captive are able to demonstrate that they can oversee and manage the outsourced risks. In this regard, it should be noted that multinationals usually use third-party service providers as captive managers and claims adjusters. Crucial for risk control in such circumstances is active decision making associated with the setting of the insurance objectives, choice of service providers & their performance evaluation and contract termination in case of non-performance. Mere parameter-setting without further involvement in managing risk may not be sufficient.

Furthermore, the captive entity needs to demonstrate its capability to establish and maintain the *financial capacity* to bear the insurance or investment risk, i.e. it is equipped with the right amount and right quality of capital. The capital to underpin (re)insurance risks does not only need to cover future claims payments that depend primarily on the nature of the (re)insurance cover, but also on some entity specific characteristics such as the level of risk diversification the entity achieves. Captive insurances are by nature less diversified as compared to commercial insurers, therefore, a slightly higher capital ratio seems to be justified. Furthermore, the quality of assets is crucial. Even if the captive's assets are sufficient to cover claims, the assets must be liquid when losses occur, thus enabling proper asset-liability matching.

Non-recognition: Critical comments on the OECDs insurance illustration

The guidelines (*Paras 1.126-1.127*) state that an arrangement between related parties can be discarded when the transaction is commercially irrational. Specific to the insurance industry, the TP guidelines discuss an example wherein a company (S1 – the insured) pays an insurance premium to a related party (S2 – the insurer) to protect its assets (plant and machinery & inventory) from frequent natural disaster (flooding) related risks. The premium amounts to 80 % of the value of its assets. It is stated that third parties will never enter into insurance contracts given that significant uncertainty exists toward large claims. As a result, there is no active market for the insurance of properties in the area where S1 has its manufacturing business. Accordingly, as third parties would never enter into such agreements, the insurance provided by S2 to S1 should not be recognized, as the arrangement is irrational for S1 from a commercial standpoint. The guidance states that either relocation or not insuring could be more attractive and realistic alternatives. Consequently, the premium paid by S1 should not be allowed as a deduction, and S2 should not be liable for any claim that arises from the insurance contract.

In our opinion, the outcome of the example is debatable. The role of an insurer is to underwrite risks. Thus, if S2 enters into an insurance transaction by undertaking an appropriate underwriting analysis, then that transaction should be respected from a commercial standpoint even though third parties would not enter into a similar transaction. Likewise, the role of an insured is to seek coverage for various risks. As S1 carries out business in an area prone to frequent flooding, it definitely requires insurance to protect its assets from damage. Thus, if S1 enters into an insurance transaction to seek coverage, then that transaction should be respected, as there is a clear business purpose to enter into it. Thus, from both S1 and S2 perspectives, the transaction does make commercial sense, as risks are transferred to a captive.

It is argued that a transaction qualifies as commercially irrational when (i) the examined taxpayer has realistically available options to adopt one or more transaction structures than the one actually adopted and; (ii) those options are clearly more attractive than the transaction actually adopted. The question arises as to what realistic options S1 has other than entering into the insurance transaction with S2. The revised guidance states S1 has the option to relocate. However, is this option a realistic one and, if so, is it more attractive to S1 than to obtain insurance from S2? The revised guidance does not provide any discussion on this issue. An independent insured, similar to S1, would have ideally asked an independent insurer for flood coverage to be limited by high deductibles and/or a fixed amount of coverage per insurance event. This would have been a realistic option, even if the insured had to pay a high premium. It is difficult for the author to imagine a situation where an independent insured would not be able to strike a deal with an independent insurer to obtain insurance on the foregoing terms. Would this option of obtaining insurance from an independent insurer be more attractive? If the independent insurance company charges a higher insurance premium than the premium charged by the associated enterprise, such an option will not be attractive. Essentially, it can thus be concluded that options which do not respect the business of the enterprise and are unrelated to the business of the taxpayer, such as relocation, can be considered unrealistic. Moreover, if the related party transaction insures an insurable risk; has sufficient risk shifting; has appropriate risk distribution (insuring third-party risks or through reinsurance), then it can be argued that the transaction is commercially rational. Applying the foregoing logic from the perspective of S1 and S2, the transaction should not be disregarded under the commercially irrational standard, as this standard provides for a high threshold. Therefore, the OECD needs to revisit its position on this example.

Conclusion

The Federation of European Risk Management Associations (FERMA) proposes a short-cut to demonstrate substance of captive entities i.e. compliance with Solvency II or equivalent regimes would not only include the proof of adequate capitalization but also the existence of key processes of risk assumption.

Moreover, according to A.M. Best's analysis 2017 European captives demonstrate particularly strong and high-quality capitalization. However**,** the authors believe the mere application of capital requirements standards like Solvency II or the Insurance Capital Standard can be misleading if taken as the only indication of appropriate capitalization for a captive. Those standards usually aim at protection of policyholders, hence focusing on defining minimum capital requirements, but not maximum capitalization. In a transfer pricing context this might be a focus area, as an "*over-capitalized*" captive can earn more investment income than an entity having only the capital available regarded as "*the appropriate amount*". (Re)insurance companies, other than captives, would naturally aim at not being over-capitalized, as this would mean that they would not be able to earn an acceptable return on capital and thus adversely affect their ability to attract and retain investors. A captive is in a completely different position: it could be favorable to the owners to accumulate capital in the captive. The authors believe tax authorities should still be cautious in assessing the '*right*' amount of capital by also recognizing capital needs above regulatory requirements, e.g. capital called for by rating agencies and the environment in which the captive operates.

Furthermore, the authors expect that new accounting standards for insurance (e.g. IFRS 17) will bring transparency into margins and maybe unexpectedly from that side enable a deeper analysis of relevant components for the delineation of the transaction such as the provision of service and insurance cover, and will shed light onto how a company estimates its own ability to take on risks by separating out the risk adjustment.

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