Praxis-Forum

Transfer pricing aspects of captive insurance arrangements: Recommendations to the OECD

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Over the past few years, tax administrations from around the world have started scrutinizing captive insurance arrangements, especially in light of transfer pricing rules. This trend will continue to increase in light of the BEPS-Action-Plan that has highlighted captive insurance arrangements as a key area of concern. Given this development, this contribution revisits the fundamental concepts of captive insurance/reinsurance and analyzes the arm’s length nature of such arrangements, particularly from the perspective of their substance, commercial rationale, pricing, possible business-restructuring issues that they may raise and documentation requirements. The analysis is done taking into consideration international case law; the current OECD transfer pricing guidelines and the revised transfer pricing guidance issued pursuant to the BEPS-Action-Plan. In light of the analysis, the contribution puts forward recommendations that the OECD may wish to consider when it issues guidance on transfer pricing aspects of captive insurance arrangements. Finally, the author concludes the contribution by providing his view on the future of captive insurance companies.

Durant les dernières années, les différentes administrations fiscales dans le monde ont commencé à scruter les arrangements de captives d’assurance, en particulier du point de vue des règles sur les prix de transfert. Cette tendance continuera à s’accroître en raison du plan d’action BEPS, qui désigne les arrangements de captives d’assurance comme un problème central. Au vu de cette évolution, la présente contribution revisite les concepts fondamentaux de captives d’assurance / de réassurance et analyse la nature « arm’s length » de ces arrangements, en particulier du point de vue de leur substance, de leur rationalité commerciale, de leur prix, des potentiels problèmes de restructuration du business qu’elles peuvent poser et des exigences en matière de documentation. L’analyse tient compte de la jurisprudence internationale, des principes actuels de l’OCDE applicables en matière de prix de transfert et des directives révisées en matière de prix de transfert selon le plan d’action BEPS. Au vu de l’analyse, cette contribution met en avant des recommandations que l’OCDE pourrait prendre en considération lorsqu’elle édicte des directives en matière de prix de transfert concernant les arrangements de captives d’assurance. En fin, l’auteur conclut sa contribution en donnant son opinion sur l’avenir des compagnies captives d’assurance.
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1 Introduction and Methodology

This contribution analyzes the arm’s length nature of captive insurance arrangements. In order to carry out the analysis, the author initially discusses the concept of insurance and reinsurance and provides a functional overview of such businesses (see sec. 2). Thereafter, an introduction to captive insurance is provided (see sec. 3). This foregoing overview provides a framework to analyze the question of under what conditions can payments made to captive insurance entities be considered deductible for tax purposes. The foregoing question is analyzed from a US perspective given that the judiciary of this jurisdiction, in comparison to other jurisdictions, has decided the issue on numerous occasions, in particular, on the concepts of risk shifting and risk distribution (see sec. 4). Thereafter, the author analyzes the transfer pricing aspects of captive insurance arrangements. Specifically, the author analyzes situations wherein captive insurance or reinsurance arrangements can be re-characterized or disregarded. When such arrangements are recognized, the author discusses the framework to determine the arm’s length nature of the premiums charged by captive insurance companies. Moreover, the author also comments on business restructuring issues that could arise in the context of captive insurance arrangements. The analysis will be done in light of international case law from around the globe, the 2010 OECD transfer pric-
ing guidelines\(^1\) and the revised guidance issued pursuant to the BEPS-Action-Plan\(^2\), in particular Action 8—10.\(^3\) The impact of Action 13 on captive insurance arrangements will also be discussed\(^4\) (see sec. 5). In light of the foregoing analysis, the author makes recommendations that the OECD may wish to consider when it issues its guidance on transfer pricing aspects of captive insurance companies (see sec. 6). Finally, the author concludes the contribution by providing his view on the future of captive insurance companies (see sec. 7).

2 The concept of insurance and reinsurance

2.1 Insurance

Insurance is undertaken to provide protection against losses. A person who provides insurance (through a policy) is known as the insurer, whereas the person who buys insurance is known as the insured or policyholder.\(^5\) The insurance policy binds the insurer to compensate an insured party against a loss in exchange for a set premium.\(^6\) Essentially, the insured is protected from various risks, and the insurer promises to compensate the insured if the risk materializes. The risk assumed by the insured for which it seeks coverage is known as the insured risk, whereas the risk assumed with providing insurance coverage is known as the insurance risk (or underwriting risk). The insurance risk is associated with the inherent uncertainty regarding the occurrence, amount or timing of insurance liabilities.\(^7\)

Broadly, the insurance industry is divided into the life and health industry, the property and casualty industry and the reinsurance industry. Insurers operating in the life and health industry segment provide insurance to cover the risk of death, disability or illness of the insured.\(^8\) The insurers in the property and casualty industry provide insurance to cover the risks associated with damage or loss of property through theft, fire or third party liability.\(^9\) The participants operating in the reinsurance industry provide insurance to insurers operating in the life and health industry or the property or casualty industry.\(^10\)

In general, an insurer’s income consists of an underwriting fee (premiums) earned through carrying out the underwriting process. The underwriting process is the process to select the risks to be insured and deciding how much to charge for them. Further, the premium that the insurer receives is invested, typically in financial assets that generate investment income (interest or dividend income). Similarly, an insurer’s expense consists of claim payments and their related expenses, underwriting expenses and expenses linked to investments.\(^11\) It should be noted that the insurance regulations of several states require insurers to set aside amounts in reserves (technical reserves or technical liabilities) that have to be used to fund claims for insured losses. Essentially, as these reserves are put in place for future claims, they are

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3 These Actions have led to changes in Chapter I (Guidance for Applying the Arm’s Length Principle), Chapter II (Transfer Pricing Methods), Chapter VI (Intangibles), Chapter VII (Intra Group Services) and Chapter VIII (Cost Contribution Arrangements) of the OECD Guidelines. See, Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, July 22 2010; see OECD/G20, BEPS, Aligning Transfer Pricing Outcomes with Value Creation, Revised Guidelines on Action 8—10, October 5 2015. The OECD Council approved these amendments on May 23 2016.
4 This Action has led to changes in Chapter V (Transfer Pricing Documentation). See OECD/G20, BEPS, Transfer Pricing Documentation and Country by Country reporting, Revised Guidelines on Action 13, October 5 2015. The OECD Council approved these amendments on May 23 2016.
5 The insurance enterprise can be set up in various legal forms. It could be formed as a stock insurer (a company with share capital), mutual insurers (without share capital and where the policy holders are the owners), cooperatives (farmer cooperatives) or fraternal or affinity benefit societies. See OECD, Taxing Insurance Companies, March 2001, p. 16; see PWC, Clarifying the rules: Sustainable Transfer Pricing in the Financial Services Sector, p. 24; SCAAR, Taxation Issues Relating to Captive Insurance Companies, pp. 1–21; Bäker, Attribution of Profits to a Permanent Establishment of an Insurance Company, p. 16.
6 The pricing of the premium depends on the frequency and the graveness of the event occurring. It takes into account the insurer’s expected costs of claims and the time when the claims are expected to be paid. See OECD, Taxing Insurance Companies, March 2001, p. 15; OECD Insurance Attribution, Attribution of Profits to a Permanent Establishment – Part IV, 2010, para. 6.
9 OECD Insurance Attribution, Attribution of Profits to a Permanent Establishment – Part IV, 2010, para. 9; the line of business for which insurance is provided is typically: motor vehicles; property (industrial, commercial or residential); marine, aviation and transport; professional indemnity; workers compensation; credit and safety. See OECD, Taxing Insurance Companies, March 2001, p. 39.
Reinsurers are typically insurance companies that absorb the risks of other insurance companies. They perform several functions, including:

1. **Solvency** - Reinsurers provide solvency protection to primary insurers by sharing the risk of insolvency.
2. **Capital Efficiency** - Reinsurers help insurance companies to maintain their capital adequacy ratios without the need to raise new capital.
3. **Risk Diversification** - Reinsurers help to diversify risk across different lines of business and geographies.
4. **Risk Management** - Reinsurers help primary insurers to manage their overall risk profile.

Reinsurers play a crucial role in the insurance industry, particularly in the following scenarios:

- **Catastrophic events** - Reinsurers help to manage the financial impact of large-scale events like hurricanes or earthquakes.
- **Large losses** - Reinsurers help to manage the financial impact of large losses on primary insurers.
- **Diversification of risks** - Reinsurers help to diversify the risk profile of primary insurers.

In summary, reinsurers are essential to the insurance industry, providing solvency protection, capital efficiency, risk diversification, and risk management services to primary insurers.
or not to enter into reinsurance;\textsuperscript{25} (vi) monitoring the insurance contracts on an ongoing basis and managing claims that arise;\textsuperscript{26} (vii) undertaking asset management activities\textsuperscript{27} and (viii) providing support services, such as treasury, regulatory compliance, credit analysis and back office services.\textsuperscript{28}

In terms of risks assumed, an insurer bears the (i) insurance risk, i. e., the probability that the underwritten risk may materialize and an amount has to be paid to the insured;\textsuperscript{29} (ii) risks related to investment activities, i. e. a market or credit risk. Market risk, also known as the investment yield risk, implies that the insurer may not be in a position to earn a sufficient return to service its claims and would therefore be required to tap into its surplus. Credit risk can typically be classified as an asset credit risk (the risk that the investee may not pay the principal and interest to the insurer), installment payment risk (the risk that the insured may default on its premium) and reinsurance credit risk (the risk that the reinsurer may not pay the insurer when a claim arises);\textsuperscript{30} (iii) risks associated with risk management and reinsurance, such as the basis risk (imperfect correlation between actual losses caused to the insurer and payments from a bond), inter-temporal risk (risk associated with changes in the books of business since the date on which the insurance policy was priced) or the retrocession risk;\textsuperscript{31} (iv) operational risks that arise from employee negligence that could ruin the business image;\textsuperscript{32} and (v) other types of risks, such as foreign exchange risks, liquidity risks or reputation risks.\textsuperscript{33} Life insurers face more significant risks, such as asset default risks, mortality and morbidity risk, interest rate risk, persistency risk, cash flow risks and guarantee and option risk.\textsuperscript{34}

In terms of assets used, insurers' main assets are their financial assets, such as debt (bonds), stocks, derivatives, real estate, policy loans and cash that generate a return on investment in the form of interest, dividends, rents and/or capital gains. Other assets that are important include accrued premiums and investment receivables.\textsuperscript{35} Insurance companies also employ tangible assets, such as office buildings (sales or claims), information processing centers, equipment and other physical facilities\textsuperscript{36} and intangible assets such as trade intangibles (underwriting tools) or marketing intangibles (such as trade names, trademarks and licenses to sell insurances in highly regulated markets).\textsuperscript{37}

3 Captive insurance

3.1 Concept and commercial rationale

A multinational group may set up captives to undertake insurance or reinsurance, i. e., insure or reinsure the risks of the group to which it belongs. It should be noted that captives acting as insurance or reinsurance companies also have to maintain technical reserves and surplus. They also have policies, policyholders and claims to manage. A key difference between a captive and a traditional insurer is that the captive is owned by the insured (or members related to the insured), whereas clients do not own an independent insurance company.

Multinationals have several reasons for forming captives as opposed to taking out insurance policies in the traditional insurance market.\textsuperscript{38} Firstly, the creation of the captive leads to a reduction of administrative costs. When an insured party purchases coverage from an insurance company, that party has to pay significant add-ons on top of costs incurred by the insurance company. For instance,
accounting, marketing, advertising or general administrative costs incurred by insurance undertakings are applied across the insurance company’s entire portfolio (client base) as opposed to being allocated on a use basis by a single big buyer. Setting up the captive ensures that the multinational need not pay for such costs.\textsuperscript{39}

Secondly, setting up the captive ensures that the multinational has to pay premiums based on good standings as opposed to bad loss records. The premiums charged by insurance companies are calculated on the basis of good and bad experiences. This means that the premiums paid by clients with a healthy financial record (low-risk clients) are sometimes similar to the premiums paid by clients with a bad financial record (high-risk clients). In other words, a company with a low loss experience subsidizes companies with high loss experiences. Accordingly, by setting up the captive, the multinational group ensures that the premiums are paid on the basis of good financial records as opposed to bad financial records. Furthermore, the pricing of premiums by independent parties is usually subject to market volatility and beyond the control of the insured party. Establishing a captive can reduce the multinational group’s vulnerability to market fluctuations.\textsuperscript{40}

Thirdly, the multinational may derive several benefits from self-insuring. For instance, the premium quoted (offer price) by an external (re)insurance company to a multinational that owns a captive is generally lower than the premium quoted to a multinational that does not own a captive, as the former has recourse to self-insurance. Accordingly, the captive acts as a good negotiation tool. This would be the case where excessively high premiums are involved.\textsuperscript{41}

Fourthly, setting up the captive gives the multinational group the opportunity to improve insurance capacity and services. It could well be possible that an independent insurance company may not provide insurance to a multinational group for certain high risks, for instance, an oil producer seeking protection against oil pollution. Similarly, the regulators of various countries may impose certain restrictions on insurance companies with respect to the risks that they can assume, for instance, contractors seeking insurance for the risks of strike caused by workers. Accordingly, by setting up the captive, the multinational group can obtain access to policies that may not be available in the traditional marketplace.\textsuperscript{42}

Fifthly, the setting up of the captive gives the multinational group access to a lower-cost reinsurance market. When a captive acts as a direct insurer or a reinsurer (that is fronted by an independent company), it gets access to the reinsurance market, i.e. the captive insurance undertaking can reinsure its risks. In general, the reinsurance market accepts larger-risk retentions and pricing that is determined on the basis of individual loss records. By setting up the captive, the multinational group can decide how much risk the captive retains and how much risk the captive can pass on to the reinsurers. Accordingly, the multinational can retain low risks (which are profitable) and pass on high risks.\textsuperscript{43}

Lastly, by establishing a captive, the multinational group is entitled to investment income. If the group had paid out insurance premiums to unrelated parties, then the group would not have been entitled to any investment returns. This is because the independent insurers would have used the insurance premiums to generate a return for their operations.\textsuperscript{44}

3.2 Types of captives

Essentially, there could be three types of captives. Firstly, a captive may obtain a license to act as a direct insurance company. Thus, the captive underwrites directly to the clients. In such cases, the captive, which acts as an independent insurance company, enters into direct insurance contracts with the policyholders, who could either be members of the multinational group (pure captives)\textsuperscript{45} to which the captive belongs or unrelated parties (diversified captives).\textsuperscript{46} Subsequently, the captive decides how much risk it retains and reinsures. Typically, captives retain a few or several layers of risks and reinsure the rest with an independent reinsurance company or captive reinsurance company that is located in the same jurisdiction of the captive or another jurisdiction. It should be noted that many independent insurers reinsure their risks with independent reinsurers. Accordingly, reinsurance is a standard feature of the insurance market. If a risk ma-

\textsuperscript{39} \text{SKAAR, Taxation Issues Relating to Captive Insurance Companies, p. 13; IAIS, Issues Paper on the Regulation and Supervision of Captive Insurance Companies, p. 12.}

\textsuperscript{40} \text{SKAAR, Taxation Issues Relating to Captive Insurance Companies, p. 14.}

\textsuperscript{41} \text{IAIS, Issues Paper on the Regulation and Supervision of Captive Insurance Companies, p. 13.}

\textsuperscript{42} \text{SKAAR, Taxation Issues Relating to Captive Insurance Companies, p. 15; IAIS, Issues Paper on the Regulation and Supervision of Captive Insurance Companies, p. 13.}

\textsuperscript{43} \text{SKAAR, Taxation Issues Relating to Captive Insurance Companies, pp. 15–16; IAIS, Issues Paper on the Regulation and Supervision of Captive Insurance Companies, p. 14.}

\textsuperscript{44} \text{IAIS, Issues Paper on the Regulation and Supervision of Captive Insurance Companies, p. 13.}

\textsuperscript{45} \text{IAIS, Issues Paper on the Regulation and Supervision of Captive Insurance Companies, p. 8.}

\textsuperscript{46} \text{IAIS, Issues Paper on the Regulation and Supervision of Captive Insurance Companies, p. 8.}
terializes, the captive indemnifies the insured. If reinsurance is obtained, the captive can ask the reinsurer to indemnify it to the extent of the reinsured risk.47

Secondly, more often than not, a captive may not obtain a license to operate as an insurance company in the jurisdiction of the member (or parent) of the multinational group. In such cases, the members of the multinational group purchase insurance from an independent insurance company (fronting company). Subsequently, the fronting company reinsures the risks with a captive reinsurance company that is part of the multinational group. Typically, the fronting company bears limited risks and passes the rest of the risks to the captive. From the premiums it receives, the fronting company retains a fronting fee (commission) and part of the premium (attributable to the risks it assumes). The rest is passed on to the captive. If a claim arises, the captive insurance company indemnifies the insurer, which in turn indemnifies the policyholder.48 In fact, the majority of the captive insurance companies in the world are reinsurance captives.49

Lastly, it could well be possible that the captive, operating as a direct insurer or reinsurer, only procures insurance from others (members of the multinational group). After procuring the insurance, the captive reinsures all its risks, as it may not be able to retain any risks of its own. In such situations, the captive does not carry out any underwriting functions and merely acts as a service provider, typically, as a broker or a fronting service provider.50

3.3 The jurisdictions for setting up captives

Multinationals may set up captives onshore, i.e., within the jurisdiction of the insured. This is the practice followed in the United States of America, where captives are set up in states such as Arizona, Hawaii, Kentucky, Montana, South Carolina, Utah and Vermont51. The key reason to set up onshore captives is to avoid the reporting obligations associated with offshore captives. Moreover, the highlighted states within the USA offer state tax savings and quality services to captives at effectively lower costs.52

Captives may also be set up in offshore jurisdictions to take advantage of flexible insurance regulations, less stringent reporting requirements and low taxes. Specifically, several offshore jurisdictions impose nil or low income taxes on the income that they receive (premiums and investment income)53. The most popular locations for setting up captives for tax reasons are (i) in the Caribbean region – Cayman Islands, Turks and Caicos Islands, Bermuda and Barbados;54 (ii) in the European Union – Luxembourg,55 Ireland,56 and Malta;57 (iii) in the Middle East – Dubai58 and Qatar;59 and (iv) in the Asia Pacific region – Hong Kong60 and Singapore.61

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47 Skaar, Taxation Issues Relating to Captive Insurance Companies, p. 9; PWC, Clarifying the rules: Sustainable Transfer Pricing in the Financial Services Sector, p. 35.
49 Aon Risk Solutions, Base Erosion and Profit Shifting (BEPS): Exploring why captive insurance companies are legitimate risk management solutions adding value to their owners, p. 18.
50 Skaar, Taxation Issues Relating to Captive Insurance Companies, p. 9; PWC, Clarifying the rules: Sustainable Transfer Pricing in the Financial Services Sector, pp. 34-35.
52 Soan/Burtwell/Smith, Captives to 2020: Opportunities and Challenges, p. 256.
54 No local taxes are levied on the Cayman Islands (however, a stamp duty is levied on insurance policies), Turks and Caicos and Bermuda (captive insurance companies receive an undertaking from the government that they are exempt from taxes up the year 2035). In Barbados, the state provides for an exempt insurance company regime and a qualifying insurance company regime. Under these regimes, the captive pays low taxes. See PWC, Captive Insurance Domicile Comparison for the Caribbean Region.
55 Captives set up in Luxembourg are subject to corporate income taxes. However, deductions can be claimed for technical provisions created by the captives. Moreover, the investment income of the captive qualifies for the domestic participation exemption regime. See PWC, Releasing Captive Value, pp. 11 – 13; Luxembourg for Finance (LFF), Luxembourg Captive Insurance Companies, p. 14.
56 Captives set up in Ireland are usually subject to low corporate income taxes (almost 12.5%). Moreover, no withholding taxes are applicable to several outbound payments pursuant to domestic law, tax treaties and European Directives. See Dublin International Insurance and Management Association (DIMIA), Captive Re/Insurance in Ireland, p. 4.
57 Captives set up in Malta are usually subject to normal corporate income taxes. Nevertheless, tax refunds are available on dividend distributions, which therefore reduces the effective corporate tax rate to almost 5%. Moreover, no withholding taxes are applicable on several outbound payments pursuant to domestic law, tax treaties and European Directives. See PWC, Insurance in Malta, pp. 90 – 93.
58 Captives set up in the Dubai International Financial Centre (DIFC) are subject to no taxes. See Truven/Cyns, Free Zones in United Arab Emirates: Domestic and International Tax Issues, pp. 475 – 476.
59 Captives set up in the Qatar Financial Centre are subject to nil taxes. See Scalia, Thoughts on the Qatar Financial Centre Sc «Concessional Rate» for Captive Insurers and Reinsurers, pp. 192 – 195.
60 Captives deriving income from insuring offshore risks are entitled to tax concessions. See Ernst & Young, Hong Kong Tax Alert, pp. 1 – 2.
61 Captives set up in Singapore can opt for a nil or reduced tax incentive. See PWC, Insurance Tax Highlights, pp. 1 – 3.
4 Deduction of insurance premiums paid to the captive – The US perspective

4.1 Preliminary remarks

In general, the premium payment made to the captive can be claimed as a deduction when the arrangement qualifies as “insurance”. The question then arises as to what constitutes “insurance” Pursuant to Sec. 162(a) of the US tax code, trade or business related payments, such as “insurance” are deductible for tax purposes. Neither the tax code nor the accompanying regulations define the term “insurance”. The US Supreme Court, in the *Le Giers* 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. It should be noted that these criteria (which are discussed below) establish a framework to determine the existence of insurance and are not independent or exclusive of each other.

4.2 The presence of an insurable risk

At the outset, it should be noted that not all risks are insurable risks and not all contracts that transfer risks are insurance policies. For instance, a contract that provides coverage against the “failure to achieve a desired investment return is an investment risk, not an economic loss giving rise to an insurance risk.” Thus, to qualify as an insurance risk, the risk associated with the policy should be a risk of economic loss suffered as a result of an identifiable hazard. In other words, insurance risk requires a fortuitous event or hazard and not a mere timing or investment risk.

Stated differently, in order to distinguish between a speculative risk and an insurance risk, Courts have found that the former risk has a potential of profit, whereas the latter risk only entails a risk of loss. A nonexhaustive list of risks that the captive can insure are risks related to property/casualty, general liability, employees benefits, workmen’s compensation, warranty or extended warranty and so on. Essentially, all facts and circumstances have to be taken into consideration to determine whether an arrangement qualifies as an insurance or investment risk.

4.3 The need for risk shifting

The insurance contract, when seen from the insured’s perspective, should shift the risk of loss from the insured to the insurer. In order to analyze whether risk shifting has occurred, separate but related insurance contracts are grouped together. Historically, the US tax authorities, 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, 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

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62 Sec. 162(a), US IRC.
63 GRIESELS-RACIN, Offshore Captive Insurance Companies Under BEPS Attack, p. 1104.
64 US Supreme Court 3.3.1941, Helvering v. Le Giers, 312 US 531, 539 (1941); also see SKAAR, Taxation Issues Relating to Captive Insurance Companies, pp. 30–33.
65 JOSEPH, Segregated Portfolio Companies and Captive Insurance Arrangements, p. 59.
69 SKAAR, Taxation Issues Relating to Captive Insurance Companies, pp. 31–32.
72 The doctrine provides that members of a multinational group constitute an economic family, and when the loss of a member is made good by another member of the family– risk shifting and risk distribution do not take place. For instance, see Internal Revenue Service, Revenue Rulings, 77-316, 1977-2, CB 53; 78-536, 1979-2 CB 107; 2001-51, 2001-26 IRB 1348; SKAAR, Taxation Issues Relating to Captive Insurance Companies, pp. 51–80.
74 ELLIOT, Captive Insurance Arrangements, p. 303.
75 SKAAR, Taxation Issues Relating to Captive Insurance Companies, pp. 103–129.

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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.\textsuperscript{76} 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.\textsuperscript{77}

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.\textsuperscript{78} 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.\textsuperscript{79} 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.\textsuperscript{80} It should be noted that, if the captive is not sufficiently capitalized for the risks it has agreed to cover, the US Courts in some situations have held that risk shifting has not taken place.\textsuperscript{81}

4.4 The need for risk distribution

The insurance contract, when seen from the insurer's perspective, should entail risk distribution. Such distribution is achieved when the insurer pools a large number of unrelated risks that are not affected by the same circumstances or events.\textsuperscript{82} As held in the Clougherty judgment

«Distributing risk allows the insurer to reduce the possibility that a single costly claim will exceed the amount taken in as a premium and set aside for the payment of such a claim. Insuring many independent risks in return for numerous premiums serves to distribute risk. By assuming numerous relatively small, independent risks that occur randomly over time, the insurer smooths out losses to match more closely its receipt of premiums.»\textsuperscript{83}

Risk distribution encompasses the law of large numbers. This theory has been described by Professor Cummins in the Amerco judgment to mean that «[a]ls the size of the pool increases, the chance that the loss per policy during any given period will deviate from the expected loss by a given amount (or proportion) declines.»\textsuperscript{84} Therefore, if the risks held by the captive are spread among a number of risks, the requirement of risk distribution is met.\textsuperscript{85}

4.5 The presence of insurance in a commonly accepted sense

Lastly, the courts have held that an arrangement qualifies as insurance in the commonly accepted sense if\textsuperscript{86} (i) the insurer was set up, operated and regulated as an insurance company;\textsuperscript{87} (ii) the insurer was adequately capitalized;\textsuperscript{88} (iii) the policies issued by the insurer were valid and legally binding;\textsuperscript{89} (iv) the premiums were reasona-


\textsuperscript{77} For instance, see US Tax Court 5.11.1992, Amerco Inc. v. Commissioner of Internal Revenue, Docket No. 91-70732; Skaar, Taxation Issues Relating to Captive Insurance Companies, pp. 120 – 135.

\textsuperscript{78} A sham can either be a sham in fact or a sham in substance. A factual sham arises where the transactions reported by the taxpayer never occurred or were only created on paper but never actually took place. If the doctrine applies, then the transactions reported by the taxpayer will be considered non-existent for tax purposes. On the other hand, a sham in substance arises when the purported transaction does not have any underlying economic substance and is undertaken solely for achieving a reduction in tax. See US Supreme Court 14.11.1960, Knetsch v. United States, 364 US 361 (1960).


\textsuperscript{80} See US Tax Court 14.1.2014, Rent A Center v. Commissioner, 142 TC 1.

\textsuperscript{81} For instance, see US Court of Appeals, Ninth Circuit 6.3.1981, Carnation Company v. Commissioner of Internal Revenue, 640 F.2d 1010; Skaar, Taxation Issues Relating to Captive Insurance Companies, pp. 135 – 145.


\textsuperscript{83} US Court of Appeals, Ninth Circuit 3.3.1987, Clougherty Packing Co. v. Commissioner, 812 F.2d 1297, para. 10.

\textsuperscript{84} US Tax Court: 5.11.1982, Amerco Inc. v. Commissioner of Internal Revenue, Docket No. 91-70732.

\textsuperscript{85} Skaar, Taxation Issues Relating to Captive Insurance Companies, p. 37.

\textsuperscript{86} US Tax Court 29.10.2014, Securitas Holding, Inc. and Subsidiaries v. Commissioner of Internal Revenue, TC Memo. 2014-225, Docket No. 21206-10, p. 27.

\textsuperscript{87} The test looks into whether the insurance company is regulated by the law of the jurisdiction in which it is set up, it keeps its books and records, it maintains separate bank accounts, it prepares financial statements, it holds its board meetings, etc.

\textsuperscript{88} The test looks into whether the insurance company's financial ratios meet or exceed the industry standard. The financial ratios provide an accurate description of the captive's ability to cover possible losses. The most important ratios are the risk retention ratio, surplus ratio, surplus ratio, reserves to surplus ratio, etc. See Skaar, Taxation Issues Relating to Captive Insurance Companies, pp. 157 – 170.

\textsuperscript{89} The test looks into whether the insurance policies issued by the captive identified the insured, contained an effective period, specified the coverage of the policy, stated the premium amount and was signed by an authorized representative of the company.
4.6 Summary – The importance of risk shifting and risk distribution

The US approach indicates that insurance payments to a captive can be considered deductible when the core requirements of «risk shifting» and «risk distribution» are satisfied. This approach also seems to be followed in other countries, such as the UK, Australia, and Norway. Essentially, risk shifting occurs when the insured no longer bears the full risk of loss and, from an economic standpoint, that loss has been shifted to the insurer. On the other hand, when seen from the perspective of the insurer, risk distribution occurs when the risks acquired by the insurer are distributed among a pool of risks such that no one claim can have an surprising adverse effect on the insurance company. The arm’s length nature of such arrangements, in particular the commercial rationale of such arrangements, is analyzed in the next section in light of the «risk shifting» and «risk distribution» requirements.

90 The test looks into whether the independent actuaries would consider the premiums reasonable. See Skaa, Taxation Issues Relating to Captive Insurance Companies, pp. 151 – 154.

91 The test looks into whether the insured paid its premiums and whether the insurer satisfied the losses. References are made to ledger entries. See Skaa, Taxation Issues Relating to Captive Insurance Companies, pp. 154 – 155.

92 It has been opined that UK tax law does not provide a definition of the term «insurance». See HMRC, General Insurance Manual, GIM 1020; nevertheless, Channell, J. in the Prudential judgment (equivalent to the US Le Gierse judgment) described an insurance contract as «a contract for the payment of a sum of money, or for some corresponding benefit such as the rebuilding of a house or the repairing of a ship, to become due on the happening of an event, which event must have [...] some degree of uncertainty about it and must be of a character more or less adverse to the interest of the person affording the insurance.» See 29.6.1904, Prudential Insurance Company v. Commissioners of Inland Revenue, 1904 2KB 658. Over a period of time, by referring to case law and economy theory, insurance exists (indicative characteristics) when (i) there is a contract for insurance; (ii) there is an insurable interest; (iii) there is a risk; (iv) the insurer agrees to indemnify the insured upon the occurrence of a hazardous event and (v) the contract involves risk transfer and risk pooling by reference to the law of large numbers. See HMRC, General Insurance Manual, GIM 1010 – 1140. Apparently, the UK tax authorities, by adopting the economic family doctrine, have tried to argue that premiums should not be deductible within a multinational group. Nevertheless, the separate entity doctrine has restricted the tax authorities from making such arguments. Accordingly, in order to claim a deduction for the insurance premium paid to the captive, the UK tax authorities have indicated that there should be significant risk shifting. Specifically, it is stated that deductions will be allowed when the premiums are at arm’s length and the captive has the necessary financial resources to meet its claims. On the other hand, the premium will not be deductible when negligible risks are insured; the captive is not able to service its financial obligations under the policy; premiums exceed the market rate; and insured losses may not be claimed. See HMRC, General Insurance Manual, GIM 11060; Grasse-Racine, Offshore Captive Insurance Companies Under BEPS Attack, p. 1109.

93 In 1994, the Australian tax authorities had issued draft guidelines on the deductibility of premium payments made to a captive insurance company. The guidance, which significantly relied on the approach adopted by the US Courts, provided that premium payments toward insurance are deductible when (i) there is a risk; (ii) there is risk shifting; (iii) risk distribution; (iv) the premium is commercially reasonable and (v) the insurer must promise to indemnify the insured in the event of a loss. It was also stated that the general anti-avoidance rule could be invoked in pure tax avoidance situations to deny a deduction for the premium payment. Moreover, the transfer pricing rules apply to determine the arm’s length nature of the premium payments. See Australian Taxation Office, Draft Taxation Ruling, TR 94/D36, 1994. In separate guidance issued in 1996 with respect to financial insurance and reinsurance, the Australian tax authorities once again stated that the elements of insurance included (i) the transfer of risk; (ii) the exposure of the insurer to significant loss as a result of the risk transfer and; (iii) the distribution of risk. See Australian Taxation Office, Taxation Ruling, TR 96/2, 1996. Subsequently, the 1994 draft guidance was withdrawn in light of the Wells judgment pronounced by the Australian Federal Court. This case focused on the commerciality of the arrangements as opposed to the criteria laid out by the tax authorities. See Federal Court of Australia 1.3.1996, WD & HO Wells [Australia] Pty Ltd v. FC of T, 96 ATC 4223. Nevertheless, it is argued that the courts' reasoning that the composite policy should be treated as «insurance» implicitly recognizes the concept of risk shifting and distribution. See Skaa, Taxation Issues Relating to Captive Insurance Companies, pp. 74 – 77. Thereafter, in 2007, the Australian tax office issued new guidance which states that, when dealing with deductions of insurance payments made to captive insurance companies, tax officers should evaluate (i) the commercial purpose of the captive insurance entity; (ii) the commerciality of the risks covered and premiums charged; (iii) the commercial manner of the captive's operations and (iv) whether risk shifting has occurred. Essentially, the foregoing criteria will indicate if the captive arrangement is a genuine commercial arrangement. If so, a deduction will be allowed for the insurance premium. See Australian Taxation Office, Taxation Ruling, PS LA 2007/8, 2007; Cio, Treatment of Non-Resident Captive Insurance Arrangements, p. 162.

94 Insurance premiums are usually considered deductible expenses. Nevertheless, with respect to intra-group captive insurance arrangements, Norwegian Courts have looked closely into the features of the insurance policy in order to establish if «insurance» has been provided. In the Schumberger judgment, the Supreme Court did not accept the economic family doctrine but held that insurance exists when there is sufficient risk shifting. Essentially, the insurance company must enter into a formal policy with the insured and should have the necessary capacities in terms of resources and funds to meet its obligations. These capacities could be secured by resorting to reinsurance too. Thus, a case-by-case analysis, by referring to independent insurance companies, will be required to determine if the captive has the financial stability to meet its exposure. Thereafter, in the Amoco judgment, the Supreme Court once again seems to have upheld that the economic family doctrine cannot be applied to deny a deduction for the insurance payments made to the captive. See Skaa, Taxation Issues Relating to Captive Insurance Companies, pp. 77 – 78.
5 Transfer pricing aspects of captive insurance arrangements

5.1 Preliminary remarks

Art. 9 of the OECD Model endorsement75 endorses the arm’s length principle for pricing transactions between associated enterprises.74 As captive insurance arrangements take place among associated enterprises, it is essential that they operate on an arm’s length basis. Whether or not the captive acts on an arm’s length basis depends on the facts and circumstances of each case. For instance, refer to the following court cases that have been decided prior to the BEPS-project.

5.2 Pre-BEPS: Judicial precedents on the arm’s length nature of captive arrangements

5.2.1 The US UPS case77

The UPS Group was engaged in the domestic and international package delivery business. For the delivery services, UPS US charged its clients a delivery fee that was calculated on the basis of each package’s weight, value, distance and accessorials services. UPS US being a regulated entity, also offered, as an additional service, insurance to customers to protect them against damage to shipments. In general, the regulatory liability of UPS US was limited to the declared value but could not exceed USD 100.— per package. In situations where the package values exceeded USD 100.—, UPS US was authorized to charge its clients USD 0.25 for each increment of USD 100.—. This additional charge was referred to as the excess value charge (EVC). The EVC charge generated more than USD 100 million for UPS US. UPS US was taxed on this income.

In 1983, in order to reduce the taxes paid on the EVC charge, UPS US established a Bermuda-based captive insurance company by the name of OPL (formerly known as UPSINCO). Employees of UPS US were appointed as directors of OPL. Moreover, an independent company managed OPL. In a nutshell, UPS US started selling insurance on behalf of an independent commercial fronting insurance provider. UPS US received the EVC income and paid a corresponding premium, net of claims, to the independent insurer. The independent insurer then entered into a reinsurance arrangement with OPL and reinsured 100% of the risks associated with the EVC charge. The contractual agreements were structured such that the EVC charge derived from selling insurance, net of a commission that was retained by the independent insurer, ended up in OPL. It should be noted that UPS US performed the same activities with respect to the EVC charge before and after the creation of OPL, in particular, activities relating to claims setting, collection and processing.

The tax authorities contended that the entire arrangement was a sham and thereby reallocated the entire EVC income to UPS US under Sec. 61 of the US IRC (income assignment provision). While making the sham argument, the tax authorities also referred to the US transfer pricing provisions (Sec. 482 US IRC). Essentially, it was argued that the arrangement was a sham, as UPS US did not charge arm’s length premiums. The case went before the US Tax Court, which held that the transactions with the independent insurer and OPL were a sham since they lacked appropriate economic substance and business purpose. Essentially, UPS US at all times controlled and performed all activities and functions that resulted in EVC revenues. Accordingly, the EVC revenues should be allocated to UPS. In order to reach this conclusion, the Court also analyzed the US transfer pricing regulations and held that the prices charged by UPS US were not done on an arm’s length basis. The Court arrived at this conclusion taking into consideration expert opinions. Specifically, an expert, Mr. Kelly, argued that no independent party would be able to charge clients USD 0.25 for each increment of USD 100.— given the fact pattern. Also, this expert provided a comparable wherein the EVC was shared between two independent parties (insurer/broker) as opposed to the entire EVC that was passed on to the independent insurer and then to OPL in the controlled transaction. Moreover, another expert, Mr. Shaprio, held that the transactions were not at arm’s length. He compared the return on equity of OPL with independent companies and held that the former’s return was significantly higher than that of the comparables. Further-

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75 OECD, Model Convention with respect to Taxes on Income and on Capital, 2014, Art. 9. Specifically, Art. 9(1) allows the tax authorities of a state to adjust the profits of the enterprises residing in that state if, as a result of the special relations between that enterprise and other associated enterprises residing in other states, the profits of the first enterprise have been diverted to the other associated enterprises, due to the fact that they operate with each other on a non-arm’s length basis.

74 OECD provisions are found in the UN Model. Further, it should be noted that the UN Model contains an additional para., i.e., Art. 9(3), which relieves the tax authority of a state from making corresponding adjustments when one of the associated enterprises, as a result of the primary adjustment, is liable for a penalty based on fraud, gross negligence or wilful default.

76 See UN, Model Double Taxation Convention between Developed and Developing Countries, 2011, Art. 9.

77 BULLEN, Arm’s Length Transaction Structures, pp. 67–82.

more, other experts (insurance experts and economists) also provided evidence that the controlled transactions were not at arm's length (see sec. 5.3.2).

The taxpayer appealed the case. The 11th Circuit\(^{98}\) reversed the Tax Court's decision. It was held that the restructing «had both real economic effects and a business purpose, and it therefore under our precedent had sufficient economic substance to merit respect in taxation.» However, the 11th Circuit remanded the case back to the Tax Court to analyze its transfer pricing implications by stating that the «tax court did not, however, reach the IRS's alternative arguments in support of its determination of deficiency, the recalculation provisions of I.R.C. §§ 482 [...]. The holding here does not dispose of those arguments, and we therefore must remand for the tax court to address them in the first instance.»

Subsequently, it is indicated that UPS entered into a settlement with the US tax authorities.

5.2.2 The Norwegian Norsk Agip case\(^{99}\)

The taxpayer, Agip, a Norwegian subsidiary of an Italian multinational group, was engaged in the business of production and pipeline transportation of oil and gas from the Norwegian continental shelf. Agip held an interest (13 %) in an oilfield (E) along with other unrelated parties, i.e., P (37 %), X (30 %), Y & Z. The field was developed with offshore installations. Each party held an interest in the installation in proportion to its interest in the field. Each party entered into insurance agreements, independently of each other, to cover the risks of physical damage to the installations. The taxpayer entered into a fronting agreement with an independent Bermuda insurance company to cover its risk. Subsequently, the independent insurer re-insured all the risks with another Bermuda captive insurance company owned by the group to which the taxpayer belonged.

It should be noted that one of the features of the insurance agreement was that the taxpayer was covered for wave damages. Historically, wave damages had a lower frequency, but during the years 1984–87, such damages appeared with higher frequency, as oil and gas extraction had led to subsidence of sea levels and thus higher waves. While the wave damage coverage for the other parties to the oilfield was fairly limited, Agip’s coverage for wave damage was not. Agip was entitled to receive up to USD 31.5 million per insurance event of wave damage.\(^{100}\) Essentially, third-party insurers were reluctant to provide wave damage coverage during the years in consideration.\(^{101}\) Moreover, the premiums paid by the taxpayer for the years 1986 and 1987 were determined on the basis of the actual cash value of the assets\(^{102}\) (ACV) as opposed to the full replacement value (FRV), the latter being commonly applied in the insurance industry. The premiums amounted to USD 11.1 million (1.15 % of FRV) and USD 9.5 million (0.94 % of FRV). The ACV of the assets on which the premiums were paid, as provided by the taxpayer, represented 85 % of the FRV values.

The tax authorities argued firstly that the taxpayer should not be given a deduction for the insurance payment attributable to the wave damage. Secondly, they argued that the level of premiums for the ACV coverage should be based on 70 % of the FRV. According to them, the taxpayer’s actual payments essentially amounted to 1.64 % and 1.35 % of the ACV, respectively. Consequently, part of the insurance payments was denied. Deduction was allowed up to the limit of 1.11 % of the ACV for 1986 and 1.05 % of the ACV for 1987.

On appeal by the taxpayer to the Appellate Body (AB), the AB held in favor of the tax authorities. The AB did not take into consideration the premium that was allocated to the wave damage risk, as it was argued (without detailed reasoning) that the risk was not justified from a commercial perspective. The AB, while accepting that the insurance was genuine insurance, agreed that the premiums should be on the ACV and that amount should be calculated on the basis of 70 % of the FRV. Consequently, the premiums paid were not at arm’s length. The AB compared the insurance premiums paid by the taxpayer to the insurance paid by the other parties to the oilfield, i.e., P, X, Y and Z, even though three out of the four parties paid premiums to captive insurance companies. Moreover, the AB also took into consideration the information provided by insurance companies (external quotes) for the rates charged on insuring similar installations and oil rigs. Essentially, the AB carried out a broad-based analysis to determine the premium rates.

The case went before the Supreme Court. The High Court held that the policy's uniqueness (lack of third-party comparables) does not lead to the conclusion that it can be disregarded. The Court found the coverage to be appropriate from a commercial standpoint.\(^{103}\) Moreover, the High Court analyzed the applicability of the CUP meth-

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\(^{98}\) US Court of Appeals, Eleventh Circuit 20.6.2001, United Parcel Service Inc. v. Commissioner of Internal Revenue, No. 00-12720.

\(^{99}\) The author did not manage to obtain a translation of this case in English. The analysis is based on secondary sources. See SOLLUND, Arm’s Length Adjustment of Premiums Paid to Captive Insurance Company Upheld, pp. 606–608.

\(^{100}\) BULLEN, Arm’s Length Transaction Structures, p. 704.

\(^{101}\) BULLEN, Arm’s Length Transaction Structures, p. 706.

\(^{102}\) Values based on the depreciated value of the installations.

\(^{103}\) BULLEN, Arm’s Length Transaction Structures, pp. 708–709.
od to this case. The Court held that external CUPs have to be considered. However, as they were not available, the Court took into consideration the premiums paid by P, X, Y and Z. The Court agreed with the AB and held that the premiums should be paid on ACV, which is represented by 70% of the FRV. The Court compared the premium rates paid by P, X, Y and Z for both years. The rates were lower than that paid by the taxpayer. Accordingly, the Court reduced the insurance amount paid by the taxpayer.

5.2.3 The UK DSG case

The DSG Group sold home electrical products in the UK. DSG Retail, Coverplan Insurance Limited and Master Plan Service Agreements Limited (hereafter grouped together as DSG UK, taxpayer’s or agents) belonged to the DSG Group. They offered extended warranties (in addition to the normal warranty) to customers when they bought goods from stores owned by the DSG Group (points of sale). Up to the year 1986, the warranties were offered by independent insurers. Pursuant to a takeover of Curry’s by the DSG Group, from 1986–1997, these warranties were insured by Cornhill, an independent UK insurance company. From 1997 onwards, due to an increase in the UK premium tax, the extended warranties were serviced by an independent company, Appliance Service Limited (ASL). In a nutshell, the agent’s services consisted of selling warranties on behalf of the independent (fronting) parties. The independent parties entered into extended warranty/service contracts with the customers and re-insured the risks (or a substantial percentage thereof) associated with the warranties/service contracts with an Isle of Man captive insurance company that was owned by the DSG Group, i.e., DISL (from 1986 onwards). DISL’s board of directors comprised of three directors who held meetings in the Isle of Man on an annual basis. Moreover, DISL had one part-time insurance employee and an investment manager.

Essentially, the contractual agreements were structured such that the income (premiums) derived from issuing extended warranties net of commissions charged by the agents and commissions charged by the independent companies ended up in DISL. It should be noted that, up to the year 1997, the captive was not provided a license to operate in the UK market as an insurance company (accordingly, the insurance was offered through Cornhill). From 1997 onwards, the captive was given a license to operate as an insurance company (accordingly, the warranty was offered through a service contract). Also, the taxpayers did not have any direct contractual relationship with the captive. The UK HMRC initiated an audit. They analyzed the level of profit earned by the captive in comparison to the commission income earned by the agents and argued that the compensation received by the latter was not at arm’s length. Accordingly, they increased the taxable income of the agents. The case went to trial, and the Special Commissioners (tribunal) held in favor of the tax authorities.

Firstly, it was held that the UK transfer pricing provisions applied to this case even though DSG UK had no direct contract with DISL. The Tribunal concluded that there was a business advantage arose through a series of transactions between related parties in order for the transfer pricing provisions to be triggered. The HMRC successfully argued that the independent parties agreed to enter into insurance agreements only on the understanding that the risks would be reinsured by DISL.

Secondly, DSG UK established that comparables equivalent to DISL could not be found. Accordingly, DSG UK argued that, in light of the various comparables put forward (CUP Method), the commission fee received by it was at arm’s length. Consequently, the entire arrangement (including the premium paid to DISL) could be considered to be at arm’s length. However, the Tribunal rejected the comparables put forward by DSG UK because of differences in market circumstances and product differences for which appropriate adjustments could not be made. Moreover, the Tribunal also provided that the point of sale advantage and the relative bargaining powers of the entities must be taken into consideration to assess the suitability of comparables. As an alternate

104 UK Special Commissioners 30.3.2009, DSG Retail Limited v. Revenue and Customs Commissioners, UKFTT 31 (TC), para. 68–93; HMRC, Transfer Pricing: Tax Cases, INTM 432055; CASEY/SINCLAIR, DSG Retail Limited v. the Commissioners for Her Majesty’s Revenue and Customs, pp. 378–385.

105 ANWORTH/SHACT, Transfer Pricing, Business Restructurings, and Intangibles, p. 771.

106 UK Special Commissioners 30.3.2009, DSG Retail Limited v. Revenue and Customs Commissioners, UKFTT 31 (TC), para. 96.


108 HMRC, Transfer Pricing, INTM 463035.

109 HMRC, Establishing an Arm’s Length Price, INTM 467085; CASEY/SINCLAIR, DSG Retail Limited v. the Commissioners for Her Majesty’s Revenue and Customs, pp. 382–383.

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to the CUP Method, DSG UK also applied the TNMM using the return on capital ratio as a profit level indicator. To this end, the return on capital (ROC) of DISL was benchmarked with the ROC of Domestic and General (D&G) Group Plc, the largest provider of off-the-shelf warranties in the UK. D&G also provided insurance to customers of small retail chains at the point of sale. The tribunal agreed that the ROC is used widely in the insurance sector. However, it rejected D&G as a comparable because of differences in its functional profile when compared to the functional profile of D&G (DISL seems to have been classified as a routine service provider). \(^{111}\)

Lastly, the Tribunal held that the profit split method should be used and the profits should be split on the basis of each party’s respective contribution. \(^{112}\) In principle, DSG UK should be entitled to a higher profit share. This was because DSG UK had provided DISL with the opportunity to enter into beneficial commercial contracts. Moreover, DISL’s profits were entirely dependent on the point of sale advantage available to DSG UK. Consequently, DISL should be given an arm’s length return on the basis of capital employed, as it was a routine service provider, and the balance should be allocated to DSG UK. \(^{113}\) The parties were instructed to adjourn the case to determine an appropriate measure of economic capital and a market rate return on that capital. It is noted that the taxpayer settled the case with the HMRC.

### 5.2.4 The Dutch holiday resort case\(^{114}\)

A Dutch holiday resort company (the taxpayer) operated a large number of holiday homes in the Netherlands. Prior to January 2001, when the reservations for the accommodations were made, the taxpayer itself provided the clients (tourists) with cancellation insurance (unless the clients opted out). The Dutch Insurance Authorities notified the taxpayer that the direct issuance of cancellation insurance contravened the Dutch insurance regulations. This was because the taxpayer did not have a license to operate as an insurance company. Consequently, the taxpayer restructured its insurance operations.

Subsequently, after 2001, the taxpayer entered into a fronting agreement with an independent Dutch insurance company (J insurance). Pursuant to this agreement, the taxpayer’s services consisted of selling insurance policies, collecting premiums, settling insurance claims, handling damage payments and drafting monthly financial statements on behalf of J insurance. J insurance entered into the contracts with the tourists and re-insured the risks with its related re-insurance company based in the Netherlands (J re-insurance). Subsequently, J re-insurance re-insured the risks with an Irish captive insurance company owned by the taxpayer. Essentially, the contractual agreements were drafted such that the income derived from issuing cancellation insurance net of commissions and fees charged by the taxpayer, J insurance and J re-insurance, ended up in the captive. It should be noted that, even though the captive was issued an insurance license, it did not employ any staff. The captive was registered at the premises of an independent Irish insurance company that belonged to the J Group. Moreover, the independent insurance company managed the captive’s entire operations. The captive’s income was comprised of net insurance premiums and income from investments. Its expenses consisted of damage payments, commissions for the J Group and administrative expenses (fees paid to the independent insurer). These funds were subsequently loaned back to the taxpayer.

The Dutch tax authorities added the income of the captive to the taxpayer. They scrutinized the contractual arrangements and argued that the taxpayer’s manner of issuing insurance, first by itself and subsequently through a fronting insurer, did not really change. Further, it was argued that the captive lacked key elements of re-insurance, such as (i) diversification; (ii) value creation by reduction of funding costs; (iii) asset/liability management activities; (iv) activities that generate the sale of insurance policies and the collection of premiums, etc. Accordingly, the captive did not carry out any re-insurance activities. The case went to trial, and the Dutch District Tax Court (The Hague) held in favor of the tax authorities.

The court ruled that the taxpayer contributed significantly toward the insurance arrangements, in particular, its customer base. Therefore, it is not appropriate to classify the taxpayer as a mere service provider and remunerate it on a commission basis. Moreover, without detailed analysis, it was ruled that the Irish captive did not bear significant insurance risk. In fact, it was held that the

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\(^{111}\) UK Special Commissioners 30.3.2009, DSG Retail Limited v. Revenue and Customs Commissioners, UKFTT 31 (TC), para. 124–131; Anslow/Shaft, Transfer Pricing, Business Restructurings, and Intangibles, p. 773; Casley/Sinclair, DSG Retail Limited v. the Commissioners for Her Majesty’s Revenue and Customs, p. 383.

\(^{112}\) UK Special Commissioners 30.3.2009, DSG Retail Limited v. Revenue and Customs Commissioners, UKFTT 31 (TC), para. 146–153.

\(^{113}\) Reinevelo/Bonkamp, Recent Case Law on Captive Insurance Companies: What is the Right Transfer Pricing Approach?, pp. 96–99; Casley/Sinclair, DSG Retail Limited v. the Commissioners for Her Majesty’s Revenue and Customs, p. 384; Anslow/Shaft, Transfer Pricing, Business Restructurings, and Intangibles, p. 774.

\(^{114}\) The author did not manage to obtain a translation of this case in English. The analysis is based on secondary sources. See Reinevelo/Bonkamp, Recent Case Law on Captive Insurance Companies: What is the Right Transfer Pricing Approach?, pp. 95–97.
Irish captive only provided administrative services that could be rewarded on a cost-plus basis. As the insurance risk was not borne by the captive, the residual insurance income should be added back to the taxpayer. The Court also ruled that the invested income earned by the captive could not be added back to the taxpayer, as the taxpayer did not undertake any investment activities. Reports indicate that the case has been appealed.

5.2.5 The Dutch re-insurance case

A Dutch mutual insurance company (the taxpayer) was in charge of providing insurance for certain risks. Up to the tax year 2002, the taxpayer re-insured the majority of its risks with an external re-insurer through an external re-insurance broker. Thereafter, effective as of 2002, the taxpayer set up a captive insurance subsidiary in Switzerland with which it concluded re-insurance contracts. The motive of setting up the captive insurance company was to provide re-insurance against 9-11 type of incidents (as independent firms did not provide such insurance after the incident). The captive insurance company, in turn, re-insured a major part of the risks with third parties and retained a few risks. It should be noted that the Swiss captive did not employ any staff. Further, its board of directors was comprised of three directors, two of whom lived outside Switzerland. Moreover, the Swiss captive engaged the services of another company, M GmbH, an external Swiss re-insurance broker. The director/owner of M GmbH (Mr. B) worked two days a week for the captive, for which the annual costs amounted to EUR 150,000. Essentially, the captive’s income was comprised of the insurance premiums from the taxpayer and investment returns (obtained from the capital invested, which consisted of the insurance premiums).

The Dutch tax authorities argued that the re-insurance agreements were not at arm’s length. They increased the taxable income of the taxpayer by adding back the premiums paid to the captive as reduced by a cost-plus remuneration for the administrative services. This was because the captive was a limited-risk service provider, as opposed to a full-fledged re-insurance company that bore insurance-related risks. Additionally, the tax authorities argued that the capital structure of the captive should be modified, i.e., the capital should be reduced in light of the non-arm’s length premiums. This had the effect of reducing the investment return for the captive, which was then allocated to the taxpayer. Alternatively, it was argued that the captive should be entitled to an investment return of 5% on the capital invested (which was comparable to a 10-year yield on government bonds) for the risks it assumed and that the return over and above that amount must be allocated to the taxpayer. Furthermore, the tax authorities levied penalties equal to 50% of the adjusted income.

The case went to trial, and a Dutch lower court held as follows. The court examined whether the terms and conditions of the reinsurance contracts were at arm’s length. The court found that the taxpayer was making decisions with respect to the activities of the captive, as the latter did not have any staff that could make the decisions concerning the re-insurance business. Further, the Court also found that Mr. B was working under the supervision and control of the taxpayer and did not have any independent decision-making power with respect to the captive. Accordingly, the captive added negligible value in the insurance/reinsurance chain. Consequently, in an arm’s length relationship, it is highly unlikely that the Dutch Co would pay an insurance premium to the captive, as it did not undertake any insurance activities (or bear the associated risks). In other words, the captive should not be entitled to disproportionate profits but should be remunerated as an administrative service provider on a cost-plus basis. Furthermore, the Court held that the capital structure of the captive should not be modified. Nevertheless, the captive should be remunerated for its investment activities by a 7.5% return on its capital employed. Hence, subsequent to the addition, the Court adjusted the taxpayer’s taxable income by reducing the cost-plus remuneration and return on capital employed.

5.3 Transfer Pricing analysis in light of international case law, current guidance and the BEPS-Action Plan

5.3.1 Delineating the controlled transaction

5.3.1.1 Article 9 and re-characterization of arrangements

Transactions undertaken by the taxpayer should be respected. However, at the outset, the question arises as to whether Art. 9(1) allows a state to re-characterize the captive insurance arrangement as structured by the taxpayer (entire arrangement or a part of the arrangement) if it is not at arm’s length.

The OECD, in the context of intercompany loans, is of the view that Art. 9(1) can be used to re-characterize transactions. It is stated that Art. 9(1)
However, this position has been criticized in academic literature. On the one hand, it is argued that Art. 9(1) can only be used to determine whether the interest rate charged on loans between associated enterprises is at arm’s length or not and cannot be used to re-characterize debt to equity. This view is based mainly on a literal reading of Art. 9(1) which provides that adjustments can be made for «conditions [...] made or imposed [...] between the two enterprises in their commercial or financial relations.» It is argued that an examination of the contractual terms which have already been made or imposed needs to be undertaken for the purpose of Art. 9(1) rather than the entire contract itself. Stated differently, the term «conditions [...] made or imposed» only refers to the terms of the contract (such as the interest rate) and not to the existing financial relations between the associated enterprises. Thus, Art. 9(1) would not permit a re-characterization of debt to equity.\footnote{117}

On the other hand, other commentators suggest that the view proposed against such re-characterization is extremely narrow, as Art. 9(1) is broad and indeed covers situations where debt can be re-characterized as equity. This is because the word «imposed» in relation to the word «conditions» indicates that not only the contractual terms but also other terms, i.e., the overall financial relations of the associated enterprises, are to be taken into consideration.\footnote{118} The author agrees with this line of reasoning and suggests that Art. 9(1) should be interpreted broadly, and the word «imposed» in relation to the word «conditions» in the sentence «conditions [...] made or imposed [...] between the two enterprises in their commercial or financial relations» indicates that not only the contractual terms but also other terms, i.e., the overall commercial and financial relations of the associated enterprises, are to be taken into consideration. This implies that Art. 9 does permit re-characterization.

Nonetheless, Art. 9(1) does not create «new» taxing rights other than those under domestic law. The provision, similar to other treaty provisions, restricts the application of such domestic law provisions. Therefore, re-characterization can be done only to the extent it is authorized by the domestic law. Accordingly, profits of associated enterprises can only be adjusted up to arm’s length conditions or an arm’s length profit.\footnote{119}

5.3.1.2 Captives' form and economic substance

The 2010 guidelines (in Sec. D of Chap. I) provide that tax administrations should analyze a transaction as structured and undertaken by the taxpayer.\footnote{120} However, in two exceptional cases, tax administrations may disregard the actual transaction or replace it with alternate transactions. The first circumstance arises when the form and economic substance of a transaction do not coincide. This is illustrated through a thin capitalization situation, wherein one related party provides an interest-bearing loan to another related party even though the latter's «relevant economic circumstances» indicate that the investment would not be structured in the form of a loan. In such circumstances, the tax authorities may characterize the arrangement in accordance with its substance and treat the funding as a capital contribution.\footnote{121}

The revised guidance also states that the application of the arm’s length principle requires a comparison of the related party transactions with comparable uncontrolled transactions. Two features of this analysis are to: (i) identify the commercial or financial terms between related parties and the economically relevant aspects attached to such terms in order to properly delineate the related party transactions; and (ii) undertake a comparability analysis to compare the controlled transactions with uncontrolled transactions.\footnote{122} The first step requires an analysis of the commercial or financial relations of the controlled transaction. Specifically, the focus is set on identifying the «economically relevant characteristics» of these commercial or financial relations. These characteristics consist of (i) the contractual terms of the transactions; (ii) a functional analysis; (iii) the characteristics of the property transferred or services provided; (iv) the economic circumstances of the parties and the market in which the parties operate and (v) the business strategies

\footnotesize{\begin{itemize}
  \item \textsuperscript{116} See OECD, Model Convention with respect to Taxes on Income and on Capital, 2014, para. 3(b), Taxation of Income, Commentary on Art. 9.
  \item \textsuperscript{117} Hosson-Michel, Treaty aspects of the «thin capitalization» issue., p. 480.
  \item \textsuperscript{118} De Broe, International Tax Planning and Prevention of Abuse, p. 505.
  \item \textsuperscript{119} Bullen, Arm’s Length Transaction Structures, pp. 67–78 and pp. 358–357.
  \item \textsuperscript{120} On the other hand, another commentator argues that Art. 9(1) does not authorize structural adjustments, see Wittendorff, The Transactional Ghost of Article 9(1) of the OECD Model, pp. 110–114.
  \item \textsuperscript{121} OECD, Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, July 22 2010, para. 1.64.
  \item \textsuperscript{122} OECD, Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, July 22 2010, para. 1.65.
\end{itemize}
pursued by the parties. The identification of these characteristics is essential because independent parties look into these characteristics in order to make decisions about whether or not to enter into a transaction. Moreover, independent parties consider the other options realistically available to them in light of these characteristics, and they will «only enter into the transaction if they see no alternative that offers a better opportunity to meet their commercial objectives.» Essentially, when the commercial or financial relations agreed between associated enterprises are not aligned with the economically relevant characteristics (or economic substance), tax authorities may delineate the transaction based on «the characteristics of the transaction reflected in the conduct of the parties» (its economic substance).

In the author’s opinion, when dealing with captive insurance companies, as a first step, it is important to analyze whether the captive’s «relevant economic circumstances» or «economically relevant characteristics» would indicate that it is actually carrying out insurance or reinsurance activities. If the facts and circumstances indicate that the captive’s functional profile (functions performed, assets employed and risks assumed) would not support its qualification as an insurer or reinsurer (even though it has received regulatory approvals to act as one), then the tax authorities may disregard/re-characterize/not recognize the captive arrangement. For instance, refer to the Dutch Holiday resort and Dutch reinsurance (starting at para. 5.2.4 above). In those cases, the Dutch courts re-characterized the arrangements in light of the captive’s functional profile due to the lack of appropriate economic substance.

Furthermore, in 2013, the Dutch Ministry of Finance issued a new Transfer Pricing decree, which discusses, inter alia, transfer pricing issues related to captive insurance. The decree states that in many situations, captive insurers or reinsurers lack the functions that professional insurers/reinsurers carry out. The functions referred to are product development, marketing and sales, acceptance of insured parties, asset/liability management and development of an independent reinsurance policy. Moreover, it is stated that such companies do not «actively» diversify risks outside the group. Specifically, in situations such as the one discussed in the Dutch reinsurance case, the decree provides that the group reinsurer (such as the Swiss entity) should be entitled only to a lower remuneration, as it carries out a mediating function as opposed to activities common to professional reinsurers. Similarly, in situations such as the one discussed in the Dutch Holiday resort case, where insurance (travel insurance) is offered as a by-product, the decree states that the group reinsurer (such as the Irish entity) should be entitled only to a minor remuneration, as it carries out merely administrative activities. The major part of the remuneration shall be allocated to the group member that offers insurance to the clients (i.e., the local Dutch taxpayer). This is because that member provides «diversification via its customer base and thereby manages to generate the insurance benefits for the group.»

The author also notes that, even though the facts and circumstances in the Dutch Holiday Resort case, the UPS case and the DSG case are quite similar, courts have taken different approaches to combat profit shifting. Income adjustments were made in the DSG case, whereas in the UPS case, it was simply held that the controlled transactions were not at arm’s length. In the author’s opinion, the US and UK courts could have also re-characterized/not recognized the captive arrangement to reflect its economic substance. This is because, in both cases, the captive did not have the appropriate functional personnel to carry out underwriting activities. In the UPS case, an external service provider managed the captive. In the DSG case, the captive had a limited functional profile. If the Courts would have followed a re-characterization approach, it is obvious that a major portion of the income would be allocated to the entity that had the point of sale advantage, i.e., the entity that provided a diversified customer base and generated significant insurance benefits for the group.

The question then arises as to the conditions under which the controlled transaction can be respected. More importantly, under which situations can the captive be entitled to insurance- and investment-related returns? The revised guidance provides that returns will be allocated to an en-

124 OECD/G20, BEPS, Aligning Transfer Pricing Outcomes with Value Creation, Revised Guidelines on Action 8 – 10, October 5 2015, para. 1.36.
126 OECD/G20, BEPS, Aligning Transfer Pricing Outcomes with Value Creation, Revised Guidelines on Action 8 – 10, October 5 2015, para. 1.120.
127 The 2010 guidance, in the chapter on business restructurings, also provides that re-characterization can take place when the economic substance of the transaction or arrangement differs from its form. Substance is determined by «examining all of the facts and circumstances, such as the economic and commercial context of the transaction or arrangement, its object and effect from a practical and business point of view, and the conduct of the parties, including the functions performed, assets used and risks assumed by them.» See OECD, Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, July 22 2010, para. 9.170.
128 Dutch State Secretary for Finance, Transfer Pricing Decree, No. IFZ 2013/184M, November 14 2013 (English Translation), para.
129 REYNOLDS/SPINKEN, New Dutch Transfer Pricing Decree, p. 122.
tity that bears the associated risks. In this regard, the following framework for analyzing risks (see Table) is provided in order to accurately delineate the controlled transaction:

| Step 1 | Identify the economically significant risk |
| Step 2 | Understand which party bears the risk contractually |
| Step 3 | Through a functional analysis, determine which party assumes and manages the risk, specifically, which party controls the risk and has the financial capacity to bear the risk |
| Step 4 | Understand whether the contractual assumption of risk is consistent with the conduct of the parties |
| Step 5 | If not, under this step, allocate the returns based on which party controls the risk and has the financial capacity to bear the risk |
| Step 6 | Delineate the actual transaction |

Essentially, the revised guidance states that the risks and returns should be allocated to the entity that controls the risk and has the financial capacity to bear the risk. In the context of cash boxes, the revised guidance has made it clear that, if an entity does not control the financial risks over the debt funding but simply acts on the direction of other members of the multinational group, then (i) that entity will not be attributed the profits linked to the financial risks and therefore will be entitled to no more than a risk-free return or; (ii) less than a risk-free return if, for instance, the transaction is not commercially justified and therefore the non-recognition rules apply.

The economically significant risk in an insurance business is the assumption of the insurance risk. The most active decision-making function that constitutes assumption of the insurance risk is the underwriting function. This function typically involves (i) setting the underwriting policy; (ii) risk classification and selection; (iii) pricing the policy; (iv) risk retention analysis; and (v) acceptance of the insured risk. In addition, other functions, such as product development, sales and marketing and risk management may constitute essential functions necessary to assume the insurance risk. Accordingly, the argument can be made that the captive should be entitled to the premiums and investment returns when it employs appropriate personnel (such as underwriters) 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 risk; and (ii) deciding whether and how to respond to the insurance 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. Additionally, the captive has the financial capacity to bear the insurance risk. This would be the case when the captive is adequately capitalized to meet its financial obligations when the risk materializes or when the captive has the necessary funds to assume and mitigate this risk by entering into reinsurance-type arrangements. On the other hand, the captive should not be entitled to the premiums or investment returns when it acts on behalf of the members of the multinational group. Thus, even if the directors of the captive formalize the decisions in the state where the captive is set up by holding local meetings, documenting minutes and signing documents, although the insurance risk-related decision was made in another state (the state of the parent company), then it is clear that the decision-making function exercised by the directors does not qualify as an exercise that demonstrates control over the risks.

130 OECD/G20, BEPS, Aligning Transfer Pricing Outcomes with Value Creation, Revised Guidelines on Action 8–10, October 5, 2015, para. 1.56 – para. 1.59; also see Verlinden/Leuven/Dessy, The Risky Side of Transfer Pricing, Sec. 3.
132 Such entities have been defined as «capital rich entities without any other relevant economic activities»; see OECD/G20, BEPS, Aligning Transfer Pricing Outcomes with Value Creation, Revised Guidelines on Action 8–10, October 5, 2015, p. 11.
135 OECD Insurance Attribution, Attribution of Profits to a Permanent Establishment – Part IV, 2010, para. 94.
136 OECD Insurance Attribution, Attribution of Profits to a Permanent Establishment – Part IV, 2010, para. 34.
137 OECD Insurance Attribution, Attribution of Profits to a Permanent Establishment – Part IV, 2010, para. 94.
139 See OECD, Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, July 22, 2010, para. 9.29 – para. 9.32. The revised guidance elaborates on this and provides that the financial capacity to assume risk can be defined as access to funding to take on the risk or to lay off the risk, to pay for the risk mitigation functions and to bear the consequences of the risk if the risk materializes. See OECD/G20, BEPS, Aligning Transfer Pricing Outcomes with Value Creation, Revised Guidelines on Action 8–10, October 5, 2015, para. 1.64.
140 Bullen, Arm’s Length Transaction Structures, pp. 492–497.
141 OECD/G20, BEPS, Aligning Transfer Pricing Outcomes with Value Creation, Revised Guidelines on Action 8–10, October 5, 2015, para. 1.66.
5.3.1.3 Commercial rationale of the captive’s insurance policy

Both the 2010 guidance (second circumstance)\(^\text{142}\) and the revised guidance provide that the related party transaction can be disregarded and replaced with another arrangement if the related party arrangement, viewed holistically, differs from those which would have been adopted by independent enterprises behaving in a "commercially rational manner;" thereby preventing the determination of a price that would be acceptable to both parties taking into account their respective perspectives and their realistically available options.\(^\text{143}\)

Specific to the insurance industry, the revised guidance discusses 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 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.\(^\text{144}\)

In the author’s opinion, the outcome of the example is debatable. At the outset, as long as the captive insurer or the insured party can demonstrate that comparable uncontrolled transactions are available, then the transaction should not be disregarded (i. e., it should be recognized). The fact that third-party comparables do not exist does not lead to the conclusion that the transaction should be disregarded.\(^\text{145}\) There could be several situations where only members of a multinational group enter into arrangements to benefit from group synergies, for instance, cash pooling arrangements.\(^\text{146}\) The 2010\(^\text{147}\) as well as the revised guidelines\(^\text{148}\) clearly state that the fact that independent enterprises do not enter into such transactions does not necessarily imply that the controlled transactions are not at arm’s length.\(^\text{149}\) Reference can also be made to the Agip case (see sec. 5.2.2). There, the taxpayer obtained insurance for wave damage that occurred with high frequency. The question was whether the insurance payment, transferred to the captive via a fronting company, for wave damage was commercially rational even though third parties did not provide coverage for such insurance. The Norwegian Supreme Court found the coverage to be appropriate from a commercial standpoint even though third party comparables could not be found. It could be argued that the Agip case findings should not be applied here. This is because OECD’s example deals with a direct situation of an insurer and insured party, whereas the Agip case deals with a captive insurer, an independent fronting insurer, and an insured party. However, in the Agip case, it should be noted that 100 % of the risks of the independent fronting insurer was reinsured with the Group’s captive reinsurer. Accordingly, a distinction cannot be made.

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 (independent) 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

\(^{142}\) OECD, Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, July 22 2010, para. 1.65.

\(^{143}\) OECD/G20, BEPS, Aligning Transfer Pricing Outcomes with Value Creation, Revised Guidelines on Action 8-10, October 5 2015, para. 1.22; See also OECD, Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, July 22 2010, para. 9.171 – para. 9.179; see also LANDS/LANCKOR/ HAFKENSCHER, (Non-) Recognition of Transactions between Associated Enterprises, pp. 90 – 94.

\(^{144}\) OECD/G20, BEPS, Aligning Transfer Pricing Outcomes with Value Creation, Revised Guidelines on Action 8-10, October 5 2015, para. 1.126 – para. 1.127.


\(^{146}\) CHAND, Transfer Pricing Aspects of Cash Pooling Arrangements in Light of the BEPS Action Plan, pp. 38 – 42.

\(^{147}\) OECD, Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, July 22 2010, para. 1.11.

\(^{148}\) OECD/G20, BEPS, Aligning Transfer Pricing Outcomes with Value Creation, Revised Guidelines on Action 8-10, October 5 2015, para. 1.123.

\(^{149}\) BULLIN, Arm’s Length Transaction Structures, pp. 536 – 537.
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 (i) insures an insurable risk; (ii) has sufficient risk shifting; (iii) has appropriate risk distribution (insuring third-party risks or through reinsurance), then it can be argued that the transaction is commercially rational (see sec. 4). 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. Nevertheless, in the author's opinion, the question may arise as to whether the premium charged by S2 (80% of the asset value) is at arm's length or not.

5.3.2 Setting arm's length prices

5.3.2.1 Introductory comments

Once the captive arrangement is recognized, a transfer pricing analysis of the captive's insurance policy needs to be undertaken. The OECD guidelines do not provide explicit guidance on determining the arm's length price of insurance premiums. Accordingly, the general principles would apply, and the captive should receive an arm's length remuneration based on the functions performed, risks assumed and assets employed. Among the various methods indicated in the OECD guidelines, international case law indicates the use of the Comparable Uncontrolled Price Method (CUP), the transactional net margin method (TNMM) or the Profit Split Method (PSM). The application of these methods in the context of captive insurance companies is discussed below.

5.3.2.2 Comparable Uncontrolled Price Method

The CUP method is considered the most direct and reliable way to apply the arm's length principle. The method compares the price charged for property or services in a related party transaction with the price charged in an unrelated party transaction. However, this may not always apply, as evidenced by the Agip case. There, the Norwegian Supreme Court compared the insurance payments made by the taxpayer to the insurance paid by the other parties to the oilfield even though several parties paid premiums to captive insurance companies. Essentially, controlled comparables were used to defend a controlled transaction. This approach, in the author's opinion, contravenes the fundamental rationale of the CUP method and should therefore be rejected. At most, this approach may serve to indicate whether other parties also seek to cover risks.

Ideally, if the captive is characterized as a direct insurer or reinsurer, then the premium rates that the captive charges to the related insured party should be compared to those charged by an independent commercial insurer or reinsurer, respectively, to an unrelated insured party (external CUP). Alternatively, the premium rates charged by the captive insurer/reinsurer to unrelated insured parties (such rates could be available if the captive is diversified) could also be used to justify the arm's length price of the rates charged by the captive to its related insured parties. Moreover, the premium rates charged by the commercial insurer/reinsurer to insured parties related to the captive could also be used to justify the arm's length price of the rates charged by the captive to its related insured parties (internal CUP). For instance, in the UPS case, the US Tax Court referred to a CUP (FFIC and PIP transaction) to establish that the EVC of USD 0.25

151 PAREKH, The Concept of "Options Realistically Available" under the OECD Transfer Pricing Guidelines, p. 302.
152 LANGER/LANKHORST/HAFENRISCH, (Non-) Recognition of Transactions between Associated Enterprises, p. 88.
154 OECD, Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, July 22 2010, Chap. II.
155 Depending on the facts and circumstances, the cost-plus and resale price method may also be used. The author does not analyze the application of these methods, as the international case law discussed in this contribution did not discuss them.
for each increment of USD 100,- charged by the taxpayer was not at arm’s length. However, as the CUP method requires a high degree of similarity between the related and unrelated party transactions, in particular, with respect to the characteristics of the goods and services, in some cases the comparables could be rejected and indirect approaches could be considered. For instance, in the DSG case, it was argued that the commission fee received by the local entities that had the point of sale advantage should be used to justify the premium paid to the Irish reinsurance captive. However, the Tribunal rejected several internal CUPs (Curry-Orion, CIS-National Satellite and the Link) and external CUPs (Office of Fair Trading Report) with respect to the commission fee because of product differences, differences in market circumstances and differences in the relative bargaining powers of the entities. Accordingly, it may be highly difficult to obtain accurately reliable CUPs given an active market for insurance does not exist and, where comparables are found, several differences exist with respect to the type of the policy, its terms, the various conditions and its pricing.

Consequently, in the author’s opinion, external quotes which take into consideration the captive’s functional, economic or market circumstances could provide good corroborative evidence to justify the arm’s length price even though they do not represent an actual transaction. Ideally, such quotes should be based on an actuarial analysis of the risks written by the captive. For instance, in the Agip case, the Supreme Court took into consideration external quotes as one of the factors to ascertain the arm’s length price of the controlled transaction (although it is unclear whether the quotes were based on a proper actuarial analysis). However, standard/off-the-shelf quotes should not be considered, as they do not take into consideration the captive’s operational profile. Likewise, expert opinions could be considered even though they should not be binding. For instance, in the UPS case, the US Tax Court referred to the opinion of Mr. Frederick Kilbourne (an actuary), who, after analyzing the losses, claim expenses, risks and other elements, established that the prices charged in the controlled transactions were not at arm’s length. Essentially, under both approaches, an actuarial appraisal methodology should be used, as an in-depth knowledge of the insurance industry is required to determine the premium rates that can be offered by insurers or reinsurers. Ideally, these approaches should be backed by the application of other methods.

### 5.3.2.3 Transactional Net Margin Method

The TNMM compares the net profit indicator (net profit relative to a base that is usually based on costs, sales or assets) of a taxpayer (tested party) in a controlled transaction with a net profit indicator of that taxpayer in an uncontrolled transaction (internal TNMM) or that of comparable uncontrolled transactions (external TNMM). While the selection of the net profit indicator depends on the facts and circumstances of each case, the return on capital employed, i.e., operating profit divided by capital employed, is a common indicator that applied in relation to capital-intensive financial activities.

This indicator has also been used to justify the arm’s length return for the captive insurer/reinsurer that economically bears the insurance risk. For instance, in the UPS case, Mr. Shapiro compared the return on equity (ROE) of OPL with independent companies and established that the former’s ROE has been «over four times as large as the highest return earned by any of the Value Line companies in any year, and its average ROE of 13.6 percent would have been almost 10 times the average ROE of 1.6 percent earned by the Value Line companies.»

As a result, it was concluded that the controlled transaction was not at arm’s length. Similarly, in the DSG case, the ROE of DISL was compared to that of D & G. However, D & G was rejected due to differences in its functional profile and relative bargaining powers for which reasonable accurate adjustments could not be made. Moreover, in the DSG case, the ROE of the fronting insurer was also compared to that of DISL. In general, it is expected that a general insurer would earn in excess of a reinsurer. However, the captive reinsurer had an ROE ten times higher than that of the fronting insurer. The Special Commissioners held that the bargaining power of the fronting insurer was higher than that of DISL, and it therefore concluded that the former (and its ROE) can-

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160 Casley/Sinclair, DSG Retail Limited v. the Commissioners for Her Majesty’s Revenue and Customs, p. 379.
161 For the methods followed by actuaries, see Bloom/Oberholtzer, The Actuary’s role in Transfer Pricing.
not be used as a comparable. Accordingly, in the author's opinion, the TNMM can be applied to an insurer or reinsurer by comparing the ROE of controlled party transactions to uncontrolled transactions.

In addition to the ROE analysis, and as an additional safeguard, the insured company could be treated as a tested party, and a return on asset (ROA) of the tested party could be benchmarked with that of comparable companies to understand whether excess profits have been transferred to the captive. Moreover, depending on the circumstances, an analysis of various financial ratios, such as loss\footnote{Casley/Sinclair, DSG Retail Limited v. the Commissioners for Her Majesty's Revenue and Customs, p. 383.} or expense\footnote{Desrochers, Insurance Transfer Pricing: Issues for Life Reinsurance Transactions, p. 18.} or combined ratio,\footnote{Loess on retained risks divided by risk premiums. This ratio indicates the percentage of net premiums that a company pays out on insurance claims. See Skaa, Taxation Issues Relating to Captive Insurance Companies, p. 177.} as applied in the insurance industry can also be done to check if the controlled transactions are at arm's length.\footnote{Operating costs divided by net premiums. The ratio indicates the relationship between the company's operating expenses and net premiums. See Skaa, Taxation Issues Relating to Captive Insurance Companies, p. 179.}

On the other hand, if the captive insurer or reinsurer is characterized as a service provider, then the captive should not be entitled to high profits.\footnote{The 2010 guidance on profit split method is currently being revised in light of the report on Action 8–10. A new report updating the changes has been issued. See OECD, Revised Guidance on Profit Splits, July 4 2016.} For instance, in the Dutch Holiday resort and the Dutch reinsurance cases, the Irish and Swiss captive were only entitled to a return on their administrative costs as they did not carry out any underwriting activity. Moreover, this would also be the case where the captive is used primarily as a negotiation tool vis-à-vis independent reinsurers for obtaining favourable pricing conditions. For example, consider the situation of a cooling equipment-manufacturing group that consists of thirty manufacturers. Each manufacturer, which is located in a different country, insures its natural disaster risk (earthquake risk) with the group captive insurance company. The captive then reinsures all its risk with an independent reinsurer by paying premiums that are lower than the premiums it receives. Essentially, the captive is able to obtain a favorable price with the reinsurer due to its collective negotiating power over the risks that have to be reinsured. If the functional analysis indicates that the captive acts as a mere service provider, i.e. it insures the risks of the members of the group and then reinsures all the risks without performing the key insurance activities such as the underwriting function, then the captive should only receive a compensation for the routine service it provides on an arm's length basis. In other words, the synergistic benefit (the difference between the premiums received and paid to the extent it is higher than the costs of compensating the captive) should be allocated to the insured parties (members of the group) as opposed to the captive itself. This could be in the form of charging reduced (discounted) premiums to the members of the group.\footnote{Such an arrangement would be similar to arrangements that only members of a multinational group enter into. For instance, a cash pooling arrangement wherein the cash pool leader acts as a service provider as opposed to an in-house bank. See Chiao, Transfer Pricing Aspects of Cash Pooling Arrangements in Light of the BEPS Action Plan, p. 45–46.}

5.3.2.4 Profit Split Method

The PSM is a two-sided method. This method aims at splitting the combined profits (or losses) arising from controlled transactions between associated enterprises on an economically valid basis, which approximates the division of profits that would have been anticipated and reflected in an agreement made at arm's length.\footnote{The PSM was applied in the DSG case. In the author's opinion, although the end result that DISL should be entitled to a ROE based on capital is suitable, the approach adopted by the Special Commissioners was not appropriate. As highlighted previously (see sec. 5.3.1.2), DISL's functional profile indicated that it was undertaking routine activities. Accordingly, it should be} The method is applied when the associated enterprises are engaged in highly integrated activities or when the associated enterprises make unique (especially in the form of unique intangibles) or valuable contributions to the transactions. In such cases, the use of the PSM is appropriate, as independent parties could wish to share the profits in proportion to their respective contributions.\footnote{Chiao/Wadze, The Profit Split Method: Status Quo and Outlook in Light of the BEPS Action Plan, p. 402.} Thus, the PSM is applicable in a situation where the functional analysis indicates that the parties involved in the transaction undertake functions that are more likely to be classified as non-routine activities as opposed to routine activities.\footnote{OECD, Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, July 22 2010, para. 2.108.} The PSM was applied in the DSG case.
characterized as a routine service provider (entitled to routine remuneration) and thus be identified as the tested party, as it did not contribute significantly toward the controlled transaction. An appropriate delineation of the transaction would warrant the application of the TNMM as opposed to the PSM.  

With respect to the division of profit, the OECD Guidelines suggest two approaches, namely the contribution analysis and residual analysis, by accepting that such approaches are neither exhaustive nor mutually exclusive. Under both approaches, the relative contributions of the associated enterprises generating the profit need to be ascertained. Thereafter, the crucial question concerns how to translate the relative contributions into a ratio for splitting the profit. In the DSG case, the contribution and residual analysis was applied in the sense that (i) the total profits were determined; (ii) from the total profits, DISL was allocated a profit that was based on its contribution that was assessed on the basis of external comparables’ ROE; and (iii) the residual was allocated to the DSG UK. The Special Commissioners held that an appropriate formula should be determined by the taxpayer and tax authorities to carry out the profit-splitting exercise.

The DSG case, quite extensively, refers to the bargaining position of the parties. In fact, bargaining theory can provide insight to determine the contribution of each associated enterprise to the transaction. The OECD Guidelines state that associated enterprises could copy the outcome of bargaining between independent enterprises on the free market to determine the profit split. Two stages are envisaged. In the first stage, the initial remuneration to each participant would be commensurate with the lowest price an independent seller would accept and the highest price the buyer would reasonably be willing to pay. The difference between these two figures would represent the residual profit over which independent enterprises would bargain. In the second stage, this residual profit would be divided based on an analysis of any factors relevant to the associated enterprises that would indicate how independent enterprises might have split the difference between the seller’s minimum price and the buyer’s maximum price. While the OECD approach seems theoretical, in practice, the game theory could be applied to determine the contribution of the associated enterprises by calculating the Shapley value of the game. The Shapley value describes a reasonable or fair way to divide gains from cooperation between parties based on the parties’ relative contributions. When using the Shapley value, the contribution of the players is assessed in relation to the incremental gain that each player brings to any coalitions and sub-coalitions. This means that the analysis aims at computing, by undertaking various permutations and combinations, the additional profit contributed by each party to the coalition of all the entities to the transaction by virtue of its own contributions. Such additional profit is the difference between (i) the profit generated by the coalition when a particular entity is a participant in the controlled transaction and (ii) the profit generated by the coalition in the absence of such entity.

5.3.3 Captive reinsurers that offer insurance as a by-product – The business restructuring issue

The OECD guidelines define business restructuring as the cross-border transfer by a multinational enterprise of its functions, assets and/or risks. Such restructurings can

178 CASLEY/SINCLAIR, DSG Retail Limited v. the Commissioners for Her Majesty’s Revenue and Customs, pp. 384.
180 Under a contribution analysis, the total profit arising from a controlled transaction is divided among the associated enterprises based upon a reasonable approximation of profit division that independent enterprises would have expected to realize from engaging in comparable transactions (comparable profit split). If comparables do not exist, the contribution analysis should be based on a detailed analysis of functions performed, assets used and risks assumed, and the variables used to divide combined profit among participants should be economically justified. Thus, the method can be applied even when a comparable does not exist (contribution profit split). OECD, Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, July 22 2010, para. 2.119; CHAND/WASH, The Profit Split Method: Status Quo and Outlook in Light of the BEPS Action Plan, p. 403.
181 A residual analysis (residual profit split) aims at dividing the total profit arising from a controlled transaction among associated enterprises in two stages. In the first stage, each participant is allocated an arm’s length remuneration for its routine contributions by applying one of the traditional methods or TNMM by referring to the remuneration of comparable transactions between independent enterprises. In the second stage, any residual profit (or loss) is allocated among the parties based on the relative contribution of each party to the transaction under consideration, OECD, Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, July 22 2010, para. 2.121; CHAND/WASH, The Profit Split Method: Status Quo and Outlook in Light of the BEPS Action Plan, p. 403.
involve the cross-border transfer of intangibles or termination of substantial renegotiation of existing arrangements. Taking into consideration the foregoing definition, in the author’s opinion, the UPS, DSG and Dutch Holiday Resort cases involved business restructurings. In those cases, the business of insuring EVC charges or warranties was developed domestically and then transferred overseas to related parties in low-tax jurisdictions.

At the outset, the question arises as to when business restructurings, as structured by the taxpayer, can be re-characterized/disregarded/not recognized. The current guidance indicates that this could happen when the economic substance of the restructuring differs from its form or when the restructuring is commercially irrational (see sec. 5.3.1). In the author’s opinion, the business restructuring undertaken by the taxpayer in the UPS, DSG and Dutch Holiday Resort cases should be disregarded, as the form did not correspond to its economic substance. This is because, even though the insurance businesses were transferred, the activities carried out by the retailers pre- and post-restructuring seem to be similar. Moreover, there is no indication that the captive had the necessary people who could effectively perform the control functions in relation to the insurance risk. Thus, an accurate delineation of the transaction may lead to the conclusion that the structure adopted by the taxpayer can be re-characterized/not recognized.

Even if the restructuring is recognized (assuming that the form and economic substance coincide and the restructuring is commercially rational), in the author’s opinion, the retailer has to be compensated appropriately. It could be argued that the restructuring involves the transfer of contractual rights, in particular, transfer of exclusive rights to reinsurance. In other words, the retailers transfer their insurance contracts made with customers to the captive reinsurer (even though it is through an independent fronting insurer. The OECD guidelines provide an example of a situation where contractual rights with customers are terminated voluntarily by one entity on the premise that the profit potential attached to those contracts is transferred to another related entity. In that situation, the guidelines suggest that the entity terminating the contracts shall be entitled to an arm’s length payment. In order to make the captive reinsurance arrangement work, the retailer enters into an arrangement with an independent insurer (fronting company) only on the condition that the latter party will enter into a reinsurance transaction with the captive reinsurer. Consequently, as seen in the UPS, DSG and Dutch Holiday Resort cases, the retailers terminate their contracts with independent customers that carry significant profit potential. Therefore, the customers are legally or commercially obligated to enter into contracts, indirectly, with a captive reinsurer. Accordingly, in such circumstances, the retailers will have to be compensated on an arm’s length basis.

5.3.4 Transfer pricing documentation

Action 13 of the BEPS plan seeks to enhance transparency in transfer pricing matters by ensuring that multinational companies disclose information to all the relevant governments as to their global allocation of income, economic activities and taxes paid among countries according to a common template. Essentially, a country-by-country reporting template is proposed along with a master file and local file. The role of the master file is to provide high-level information about the multinational group, such as the organizational structure, description of business and what drives value in it, intangible assets, intercompany financial transactions and the multinational’s financial and tax positions. The role of the local file is to provide a detailed analysis of the application of the arm’s length principle with respect to the transactions that take place between the local country affiliate and the associated enterprises in different countries. The country-by-country report, which must be filed annually, requires multinationals to provide information (such as revenues, profit before taxes paid, employees, etc.) for each tax jurisdiction in which they operate. Moreover, at the EU level, a similar initiative on automatic exchange of country-by-country reporting has


192 BRANBERNER, Transfer Pricing in BEPS: First Round – Business Interests Win (But, Not In Knock-Out), pp. 79–84.


been agreed. Consequently, intra-group captive arrangement transactions will have to be reported pursuant to these documentation requirements. The disclosures will provide a comprehensive view to the tax authorities on how a multinational organizes its captive insurance activities.

6 Recommendations to the OECD in light of the foregoing analysis

An analysis of the case law in this contribution indicates that captives have been used to erode tax bases and shift profits. Accordingly, the author agrees with the drafters of the BEPS plan that captive insurance arrangements are a key area of concern. Several Actions of the BEPS plan (in addition to the Actions that deal with transfer pricing) have a direct impact on captive arrangements. For instance, Action 3, which deals with the issue of controlled foreign companies; Action 4, which deals with limiting interest deductions; Action 5, which deals with countering harmful tax practices; Action 6, the fixed ratio rule. This approach would enable entities with a net interest expense above a country's fixed ratio rule to deduct interest up to the level of the net interest/EBITDA ratio of its worldwide group. The report recognizes that the banking and insurance sectors have specific features which must be taken into account and therefore there is a need to develop suitable and specific rules that address BEPS risks in these sectors. Further work in this area is expected. However, the report at the same time provides that any exclusion should not apply to captive insurance entities and that they should be subject to the fixed/worldwide ratio rule. These developments could restrict interest paid by captive insurance entities even if the funding and corresponding payments are at arm's length. See OECD/G20, BEPS, Limiting Base Erosion Involving Interest Deductions and Other Financial Payments, Action 4—2015 Final Report, October 5 2015; Hülshöss et al., Transfer Pricing Implications of Action 4 under the OECD's BEPS Initiative, Sec. 4.

The final report deals with countering harmful tax competition, taking into consideration transparency and substance. It states that the OECD/G20 countries agree to strengthen the 'substantial activity requirement' that has been used to assess preferential tax regimes. Specifically for intellectual property (IP) box regimes, the report proposes the nexus approach. Under this approach, profits made by a taxpayer utilizing an IP box regime are exempt only to the extent the taxpayer itself incurs the qualifying research and development (R & D) expenses that gave rise to the IP income. The idea behind the requirement is that the taxpayer should actually carry out the activity and incurs the related expenses in order to benefit from these regimes. This requirement has also been extended to non-IP regimes. Accordingly, taxpayers can benefit from other regimes, such as insurance regimes, to the extent that the taxpayer itself undertook the 'core income-generating activities' required to produce the type of income covered by the regime in question. Such activities could include 'predicting and calculating risk, insuring or re-insuring against risk, and providing client services.' Essentially, this would mean that the entity has well-qualified and knowledgeable staff that can handle decisions with respect to the insurance risk. This approach seems compatible with the transfer pricing notion of control over the insurance risk. Accordingly, a reasonable statement can be made that, if the necessary 'economic substance' exists for transfer pricing purposes, then the 'substantial activity requirement' should also be met. Moreover, to promote transparency, the final report advises states to exchange information on preferential tax rulings on a compulsory spontaneous basis in order to avoid BEPS concerns. Such rulings include rulings on preferential regimes (such as insurance regimes) or unilateral advance pricing arrangements (APA) in respect of transfer pricing. See OECD/G20, Countering Harmful Tax Practices More Effectively, Taking Into Account Transparency and Substance, Action 6—2015 Final Report, October 5 2015.

Action 6 of the BEPS-plan deals with preventing treaty abuse. The final report suggests countries incorporate a minimum standard by changing the title and preamble of their treaty to reflect the objective of preventing treaty erosion and tax avoidance (including treaty shopping) coupled with either (i) a principal purpose test (PPT rule) and limitation of benefit (LOB) clause or (ii) a LOB clause with a narrow PPT rule for conduit financing situations or (iii) only the PPT rule. These changes could impact captive insurers set up in jurisdictions with strong treaty networks, such as Ireland, Luxembourg and Switzerland. Depending on the facts and circumstances of each case, it could well be possible that a captive insurance entity does not qualify as a 'resident' for tax purposes, as its effective manage-
which deals with preventing treaty abuse; and Action 7, which deals with circumventing the permanent establishment definition. These Actions may restrict several tax benefits currently enjoyed by captive insurance entities/arrangements.

On the transfer pricing front, the OECD has indicated that further work will be undertaken with respect to developing transfer pricing guidance on «pricing [...] captive and other insurance arrangements». Such guidance will be welcome given that the Court judgments discussed in this contribution clearly show that tax authorities have started questioning the arm's length nature of captive arrangements, especially with respect to delineating the transaction in light of the entity's substance and determining the arm's length price of the insurance policies.

With respect to delineating the controlled transaction, the guidance provided by the OECD on risk and returns is sufficient to address the situation wherein the form of the captive arrangement does not coincide with its economic substance. In the author's opinion, the captive should be entitled to insurance premiums and investment returns only when it employs appropriate personnel (such as underwriters) 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 risk; and (ii) deciding on whether and how to respond to the insurance risk associated with the decision-making opportunity. Moreover, the entity must also demonstrate that it can perform the decision-making activity associated with the insurance risk. Furthermore, even if the management of risks is outsourced, the personnel in the captive must have the capability to demonstrate that they can oversee and manage the outsourced risks. Additionally, the captive must have the financial capacity to bear the insurance risk. This would be the case when the captive is adequately capitalized to meet its financial obligations when the risk materializes or when the captive has the necessary funds to assume and mitigate this risk by entering into reinsurance-type arrangements (see sec. 5.3.1.2). On the other hand, with respect to the commercial rationale of the captive arrangement, the author suggests that the OECD revisit its BEPS guidance, in particular, its «insurance» example. Specifically, in the author's opinion, if the captive arrangement involves the insurance of an insurable risk, has sufficient risk shifting and appropriate risk distribution, then that transaction should not be considered to be commercially irrational. Accordingly, the example provided by the OECD should be modified or deleted (see sec. 5.3.1.3).

With respect to pricing the controlled transaction, the OECD does need to provide further guidance. Logically, the pricing of the transaction would depend on the facts and circumstances of each case. Nevertheless, the first method that could be applied in captive arrangements is the CUP method. It should be noted that it may be highly difficult to obtain accurately reliable CUPs and, where comparables are found, several differences exist as to the type of the policy, its terms, the various conditions and its pricing. Accordingly, captive insurers or reinsurers should use an actuarial analysis to determine the premium rates that can be offered. In addition to the CUP method, the TNMM can be applied to a captive insurer or reinsurer by comparing the return on equity of controlled party transactions to uncontrolled transactions. Moreover, depending on the circumstances, an analysis of various financial ratios, such as loss or expense or combined ratio, as applied in the insurance industry, can also be done to check if the controlled transactions are at arm's length. Additionally, it should clearly be stated that if the captive insurer or reinsurer is characterized as a service provider then the captive should only be entitled to a routine return. Specifically, synergistic benefits should be allocated to the related insured parties as opposed to the captive itself when the latter performs basic functions (only negotiating pooled risks) without any value addition (such as undertaking underwriting activities). The PSM, in the context of captives, should be applicable only when the functional analysis indicates that the parties involved in the transaction are carrying out high-value added functions. This would typically be the case.

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201 Action 7 of the BEPS plan deals with artificial avoidance of PE status. The final report suggests states makes changes to the definition of PE as found in Art. 5 of the OECD Model. In particular, changes are recommended for (i) Art. 5(3) to combat the splitting-up of construction related contracts; (ii) Art. 5(4) to combat fragmentation of activities in order to qualify them as preparatory and auxiliary activities and (iii) Art. 5(6) and 5(6) to combat commissionaire structures. The issue of an insurance enterprise selling insurance through exclusive agents in another state is also discussed. The report provides that «it is conceivable that these companies do large-scale business in a State without being taxed in that State on their profits arising from such business.» After discussing whether or not a separate insurance PE rule was required or not, the report concluded that such a rule is not warranted. See OECD/G20, Preventing the Artificial Avoidance of Permanent Establishment Status, Action 7 – 2015 Final Report, 5 October 2015.
where the captive is actively carrying out the underwriting function and the associated enterprise (for instance, a retailer with a point-of-sale advantage) is selling the insurance policy on an active basis. On the other hand, the PSM should not be applied when one party is carrying out high-value added functions and the other party is carrying out routine services.

7 The future of captives: Are they dead or still alive?

As the BEPS-Action-Plan has a significant impact on the captive insurance industry, a question can be raised, from a conceptual point of view: What is the future of such businesses? In the author’s opinion, captive business models that lack economic substance or commercial rationality will be «dead» in the near future. Such arrangements, which will be transparent pursuant to the revised transfer pricing documentation requirements, i.e., country-by-country reporting, will be exposed to significant transfer pricing (and tax) disputes.\(^{202}\) It should be noted that this conclusion is nothing new and should have been the case far before the BEPS reports were delivered. On the other hand, captive business models would be «alive», from a transfer pricing perspective, if they have high operational substance and strong commerciality. This can be demonstrated if the captive insurer or a reinsurer, in addition to having a board of directors,\(^{203}\) also have an executive, an underwriting and a claim management team that actively take decisions with respect to their activities.\(^{204}\) Such operational substance would ensure compliance with the main theme of the BEPS-plan, i.e., to align taxation with value creation. Moreover, such captives will have to engage in acceptable policy pricing approaches, especially by undertaking «actuarial analysis.» However, in the author’s opinion, the greatest challenge for such «alive» entities is the application of CFC rules. It could well be possible that income (insurance and investment income) derived by captive entities, even though they are at arm’s length, could be subject to the CFC rules of the shareholder state. Consequently, «alive» captives operating in low tax jurisdictions (see sec. 3.3) could be «dead» unless and until they are exempted from the application of domestic CFC rules.

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202 For such arrangements, multinationals should consider dispute prevention avenues such as entering into bilateral advance pricing agreements (or even, when possible, a multilateral advance pricing agreement) with the relevant jurisdiction(s). Alternatively, for disputes under litigation, the author suggests taxpayers resort to the mutual agreement procedure, including possibly arbitration (including mandatory arbitration), as provided in Art. 25 of the OECD Model. It should be noted that Art. 26 of the OECD Model, which provides for a dispute resolution mechanism, i.e., the mutual agreement procedure (MAP), is also applicable to transfer pricing disputes. It is contended that the current MAP process is ineffective, as many cases go unresolved. Action 14 of the BEPS plan revisits the dispute resolution mechanism and seeks to make the MAP process more effective. The final report provides for implementation of minimum standards through a peer-based monitoring mechanism. In addition to committing to the minimum standard, several countries have also expressed their interest in implementing mandatory arbitration clauses in their tax treaties. See OECD/G20, BEPS, Making Dispute Resolution Mechanisms More Effective, Action 14, October 5 2015, pp. 9–10; see also Malherbe, The Issues of Dispute Resolution and Introduction of a Multilateral Treaty, pp. 91–93.

203 In a nutshell, the board of directors will be responsible for providing strategic input, undertaking governance and taking ultimate decisions with respect to underwriting, Investment and claims management.

204 In a nutshell, this team will be responsible for performing operational functions, carrying out the underwriting activities, processing claims and overseeing the work of outsourced service providers.
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