Executive summary

This alert sets out how recent developments in the global tax environment may impact UK-connected groups with a captive insurer located anywhere in the world.

Political and public pressure for increased tax transparency has gained momentum in the last few years, resulting in responses such as the Organisation for Economic Cooperation and Development (OECD) Base Erosion and Profit Shifting (BEPS) project. During this time, the focus has sharpened on captive insurers with captive arrangements specifically referenced as part of the BEPS project and, in some countries, subject to specific tax treatment such as under the UK’s controlled foreign company (CFC) regime.

Certain countries have introduced anti-avoidance legislation in response to BEPS Action 7 and Actions 8-10 with the most notable development being the diverted profits tax (DPT) recently introduced in the UK. The UK DPT takes effect from 1 April 2015 and can potentially affect captive insurers located anywhere in the world whether the affiliated group is headquartered in the UK or overseas. Guidance released by HMRC in respect of the DPT contains a specific captive insurance example that illustrates the trend of increasing scrutiny and risk of challenge for these arrangements.

Captive insurers in low-tax jurisdictions with low substance are at a high risk of being caught by these anti-avoidance regimes.

DPT risk assessment, liability quantification and approach to HMRC engagement are complex areas and a UK CFC apportionment of a captive’s profits does not prevent the DPT from applying. We therefore recommend all groups with captive insurers consider a risk review without delay and, in any event, before the end of the first year DPT notification period.

Background

Captive insurance has a long history in the UK with the earliest captives having been established in the 1920s. A captive (which must be a licensed insurer) provides insurance to its non-insurance affiliates and operates in a similar manner to a commercial insurer. The majority of the largest UK groups have captive insurers and many of these have been in existence for a number of years.
The captive insurance industry was initially formed due to difficulties in obtaining certain types of insurance coverage from traditional insurers in the third party market. Captives can provide coverage for a wide range of risks and enable a group to pool global risks and achieve diversification benefits. Captive arrangements commonly involve low-tax jurisdictions and, in some cases, a third party fronter. Group-wide insurance arrangements are also common with the parent company negotiating an ‘umbrella’ arrangement on behalf of group affiliates.

It is important to distinguish captives from intra-group reinsurance entered into by affiliates within a regulated insurance group. A captive operates in a similar manner to a commercial insurer; however, the underlying risks of a captive are not third party and are therefore subject to different licensing and regulatory requirements. Tax authority behaviour is typically more aggressive in nature as regards to captive arrangements.

Transfer pricing for captive arrangements

UK transfer pricing rules apply the ‘arm’s length principle’ under the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (the OECD Guidelines) which seek to prevent companies from obtaining a UK tax advantage by entering into transactions with either UK or non-UK connected parties. DSG Retail Ltd and others v RCC (2009) was the first ever UK case to consider the application of the arm’s length principle and established that taxpayers need to consider the bargaining position of each of their related parties and the factors that convey an economic advantage to them. The case considered transfer pricing between the appellant companies and the group’s insurance subsidiary in the Isle of Man that insured or reinsured, through a third party, the liability to customers for extended warranties. The case demonstrated HMRC’s willingness to litigate on transfer pricing and increased scrutiny around captives. From a transfer pricing perspective, captives are likely to be subject to even further challenge by tax authorities going forward, particularly in light of the OECD BEPS project and ‘fair tax’ debate which have highlighted captive structures as a key focus area. HMRC is becoming increasingly sophisticated and allocating more resources to challenging transfer pricing arrangements with industry specialists.

It is important for organisations to understand the transfer pricing risk of captive arrangements in view of their current operating model and framework to avoid any recharacterisation of transactions. Organisations may wish to address controversy issues and obtain certainty from tax authorities where appropriate, bearing in mind developments elsewhere in the tax landscape.

In the UK, Advance Pricing Agreements (APAs) can be negotiated with HMRC. When the terms of the APA are complied with (i.e. there are no material changes in fact and operations from that on which the APA was based), it provides assurance that the transfer pricing will be accepted by HMRC for the period covered by the APA. The APA would also be expected to set out certain circumstances under which the agreement may be revised or revoked by HMRC. HMRC has recently advised that APAs agreed after 1 April 2015 will include a review of the DPT position.

UK diverted profits tax

The UK introduced legislation for the new DPT to apply from 1 April 2015. It is an anti-avoidance measure aimed at perceived abuse in certain circumstances involving insufficient economic substance or avoided UK permanent establishments (PEs). The DPT acts by imposing a tax charge of 25% on profits diverted from the UK in either of these two situations and will have significant implications for captives.

Avoidance of a UK taxable presence

The first type of arrangement targeted by the DPT rules is where a person (whether UK resident or not) carries on activity in the UK in connection with the supply of services, goods or any property by a non-UK trading company, and it is reasonable to assume that no PE is established in the UK. Where, in such circumstances, there are arrangements in place one of the main purposes of which is to avoid UK corporation tax, or where the company is party to arrangements with an affiliated company that produce a ‘tax mismatch’, the provisions can apply.
This may in some circumstances apply to fronting arrangements where a UK team is fronting for an overseas company that then directly contracts with customers. It may also apply to groups which have a UK broker acting on behalf of an affiliate insurance company where brokerage commission is payable to the UK, or where a UK individual with a dual role is managing the captive or outsourcing arrangements from the UK.

**Insufficient economic substance**

The second type of arrangement targeted by the rules is the situation where a UK resident company (or a UK PE of a non-UK resident company) is party to arrangements with an affiliated company that produce an ‘effective tax mismatch’ and the ‘insufficient economic substance’ condition is met.

This section is a key concern for captives as this seems to target any type of intra-group cross border arrangement where it is reasonable to assume it is designed to secure a tax reduction and therefore could potentially apply to any type of captive insurance arrangement with affiliates in low tax jurisdictions.

The result of the provisions applying is to impose a DPT charge equal to 25% of the ‘diverted profits’. Under the first type of arrangement, these are profits that would have arisen had a PE existed. Under the second type of arrangement, the 25% charge is applied to the additional profits that would arise, based on correct transfer pricing. Where the relevant transaction or provision would not have been entered into if tax had not been a consideration, an alternative provision can be substituted that is just and reasonable to assume would have been entered into in the absence of tax considerations. Furthermore, if that alternative provision would have resulted in income arising in a company that is chargeable to UK corporation tax, then that income is included in the taxable diverted profit.

The DPT assessment and collection procedure is based on a duty on the company to notify HMRC within three months of the end of an accounting period in which it is reasonable to assume that diverted profits might arise. The rules contain an extension of the notification period to six months for accounting periods which end on or before 31 March 2016. There is a tax-gearued penalty for failure to notify.

HMRC published DPT guidance on 30 March 2015 which includes an example involving a captive insurance arrangement between a UK company and a captive insurer in a low-tax jurisdiction. The analysis concludes that a DPT charge would arise on the basis that there is no economic benefit directly related to the movement of the insurance risk and there are no commercial motives for the transaction other than the tax saving. The guidance emphasises that the same analysis would apply if a third party fronting company had been interposed between the UK company and captive.

It is not clear from the example whether HMRC continues to accept that there could be economic benefits and commercial motives associated with captive insurance; certainly the public consultation document released in 2011 on the UK CFC reform acknowledged at the time that captive insurance by non-insurance groups ‘has the potential to offer some commercial benefits to the group’.

Captive insurers, particularly those that write a single contract of insurance, are at a high risk of being caught by the DPT. Groups with captives, or brokers that offer captive solutions, should assess the implications of the DPT on their business, articulate their non-tax benefits, review their substance and consider engaging with HMRC where appropriate. It is important to note that, even where a DPT charge does not arise (for instance as a result of credit provisions), there may still be a notification requirement. DPT has placed even greater focus on the transfer pricing aspects of captive arrangements. However, the DPT rules go beyond the current ‘arm's length principle’ in the OECD Guidelines by recharacterising transactions even where they are priced at arm’s length.

**UK Controlled Foreign Company regime**

Guidance released by HMRC notes that captive insurance companies resident in beneficial tax regimes have always been a concern for fiscal authorities since they were a primary driver behind the introduction of the UK CFC regime in 1984. Public consultation on the UK CFC reform identified the ability for non-insurance groups to use captive insurance in certain cases to artificially divert UK profits. The captive insurance example contained in the CFC consultation document aligned with many of the facts established as part of the DSG Retail case referred to above and represented a clear
signal that HMRC was looking to target these types of arrangements as part of any new CFC regime.

The ‘new’ UK CFC regime applied from 1 January 2013 and contains specific provisions (Chapter 7 of the rules) that relate to captive insurance businesses following active lobbying from the industry as part of the consultation process. Broadly, the rules apply to underwriting profits generated from insurance premiums received from certain UK insurance contracts and profits generated from the investment of those premiums. Where the CFC rules apply, underwriting profits and investment income are subject to tax in the UK. There are specific rules for captive insurers resident in an Economic European Area (EEA) territory such that it only applies to the extent there is no significant UK non-tax reason for entering into the insurance contract.

The current UK CFC rules therefore operate to distinguish between captive insurance in a non-insurance group versus intra-group reinsurance in a regulated insurance group, and assess the CFC position of a captive based on the location of underlying risk and by applying a tax purpose test under certain circumstances.

**Interaction between UK diverted profits tax and Controlled Foreign Company rules**

The final DPT legislation contains provisions that enable a company to apply a credit against a DPT charge for tax paid on profits under the UK CFC regime or under an equivalent CFC regime outside of the UK. Such credit provisions apply after the notification provisions and therefore companies may be required to notify HMRC of a potential DPT liability notwithstanding the fact this may be partially (or wholly) mitigated by a CFC charge. It should be noted that there will be a rate differential between the DPT and the CFC charge even if these are charged on the same profits, given the higher rate of DPT than the UK corporation tax rate.

The fact that a captive is subject to a CFC charge does not necessarily preclude DPT from applying. In particular, the CFC regimes both in the UK and outside of the UK apply different tests as compared with those under the DPT. For instance, Chapter 7 of the CFC rules applies a test based on the situs of risk and brings in a tax purpose test for EEA captives, both of which are very different from the factors assessed by the DPT rules.

Similarly, Chapter 4 of the CFC rules (Profits attributable to UK activities) apply a significant people function test which differs from the financial benefits test under the DPT rules. However, where it was known at the time the relevant transaction was entered into that there would be a CFC charge, then it might not be reasonable to assume that the transaction was designed to secure a tax reduction and in which case DPT should not apply. However, where there was no CFC charge at the time the transaction was entered into, even if there is at a later date, or because of the different mechanics of the CFC and DPT rules, a DPT charge may still apply. A CFC charge may provide only partial mitigation against a DPT charge depending on the method of calculation. For instance, in the case of a captive where Chapter 7 applies, the calculation of a CFC charged is based on the captive’s profits which would likely be significantly lower than ‘taxable diverted profits’ calculated under the DPT rules which are based on the UK premium paid.

**UK Summer Finance Bill 2015**

The UK Summer Finance Bill 2015 announced that, from 8 July 2015, a CFC charge can no longer be reduced by the losses of UK companies, whether the losses are brought forward losses, current year losses or losses surrendered as group relief from elsewhere in the group.

Accordingly, where before a CFC charge on a captive insurer’s profits was sheltered by UK losses, a CFC charge will now be payable plus a likely top up DPT charge after allowing credit for the tax paid under the CFC regime.

**OECD BEPS issues for captive insurers**

**Action 3 (Strengthening CFC rules)**

On 3 April 2015, the OECD released a discussion draft in connection with Action 3 (Strengthening CFC rules) under the BEPS project. The discussion draft identifies seven core elements of CFC rules and provides recommendations or options for the design of such elements. One of these seven core elements is the definition of CFC income. The proposal emphasises the importance of accurately defining income in the context of CFCs that engage in services of captive insurance and reinsurance. The discussion draft outlines that groups not involved in insurance activities may establish captives which are often in low-tax jurisdictions and,
by various means, insure risks associated with the groups normal business activities with the captive and thereby shift profit to the captive. The discussion draft notes that, generally speaking, limited activity is required in the management of these captive operations and taxing authorities may not have the ability or capability to successfully challenge the extent to which companies have actually transferred the risks to related CFCs.

Although the outcome of Action 3 is not clear, HMRC has indicated that, having recently consulted extensively on the UK CFC regime and undergone a significant reform of the rules, it is now content with the UK CFC rules. It may therefore be that no changes will be made to the UK CFC rules following conclusion of the OECD project. Groups are advised to assess these impacts on a global basis.

**Action 7 (Preventing the artificial avoidance of PE status)**

On 15 May 2015 the OECD published a revised discussion draft in relation to Action 7 (Preventing the artificial avoidance of PE status). Action 7 is seeking to introduce a reduced threshold for deeming a PE which will be wide-reaching. The original proposal of a specific insurance rule has been removed and therefore the general changes being proposed will be relevant.

Action 7 is particularly relevant for captives where a UK broker acts on behalf of the captive or where a UK individual with a dual role is managing the captive or outsourcing arrangements from the UK. Part IV of the OECD report on the attribution of profits to PEs contains extensive guidance on the attribution of profits to an insurance PE and there is uncertainty as to how this will be impacted by the Action 7 proposals.

**Actions 8 – 10 (Risk and recharacterisation)**

Actions 8 – 10 (Risk and recharacterisation) propose a rewrite of Chapter I of the OECD Guidelines and propose certain specific measures. This is widely drafted and subjective in nature, and the revised guidelines change the way in which transactions are assessed under the arm’s length principle. This will include requirements to consider the options realistically available to parties, a two-sided test for both parties and the benefits for the group as a whole. There will be increased focus on evidencing how compelling the commercial drivers are for captive arrangements and how the risks are taken and supported, including the return on capital generated by the transaction.

Although a final draft of the revised Chapter I is expected in October 2015, the OECD has recently announced that there will be further work carried out in 2016 and 2017 for financial services groups, which may include further changes to Chapter I guidance.

**Action 13 (Country-by-country reporting)**

Action 13 (Country-by-country reporting) proposes a three-tier reporting requirement for fiscal years beginning on or after 1 January 2016 in the form of a master file, local file and country-by-country (CbC) report. The master file contains high-level information on the business and transfer pricing policies on a group-wide basis, and the local file will contain information on specific local transactions. The CbC report will provide information including the jurisdictional allocation of profits, revenues, taxes paid, employees and assets.

It is crucial for organisations to assess their ability to source financial data for the purposes of compiling the CbC report and a number are performing a ‘dry run’ during 2015 based on prior year information and financial data. For groups with captive arrangements in low-tax jurisdictions there are further considerations as to how tax authorities might interpret information, such as headcount, profits and taxes paid, disclosed as part of the CbC report. Furthermore, this information may become publicly disclosed in the near future given the various groups calling for such publication. Groups may want to consider their approach in light of all of the proposals.

**Implications**

The interactions between these measures are complex. Groups with captives, or brokers marketing captive solutions, should evaluate the implications of current developments in the tax landscape to understand any risk exposure from an operating model, tax transparency and reputational standpoint. Groups may then need to consider how such risks can be remediated and identify, design and develop processes to ensure they are meeting compliance requirements and managing brand reputation. Although a number of tax developments have not reached a conclusion, others have already been enacted into law and it is clear that these issues will remain an area of focus for tax authorities over the coming years.
Significant tax changes: UK implications for captive insurers