Executive summary

Over the last five years global tax authorities have increasingly scrutinized captive insurance arrangements, focusing on questions relating to substance, commercial purpose and pricing. In what is likely to further reinforce this trend, the main workstreams of the two-year Organisation for Economic Co-operation and Development (OECD) Base Erosion and Profit Shifting (BEPS) project concluded in October 2015 with a series of measures that bring fundamental changes to the international tax landscape and could significantly impact captive insurers. While some of the OECD changes have yet to be fully concluded or implemented in European Union (EU) Member States, others may have immediate effect in some jurisdictions through existing domestic legislation. The OECD will be undertaking further work during 2016 and 2017 to establish specific guidance on the transfer pricing of financial transactions, which includes captive insurance arrangements.

In addition, on 28 January 2016 the European Commission released an anti-tax avoidance package including a proposed EU Anti-Tax Avoidance Directive (ATA Directive) with a view to future implementation by EU Member States. Although discussions held at the EU’s Economic and Financial Affairs Council (ECOFIN) meeting on 12 February 2016 indicate that the ATA Directive will unlikely be introduced in its present form, groups with captive insurers are at risk of being
subject to further scrutiny from tax authorities as countries begin to implement the outcomes of the OECD BEPS project. With this in mind, groups with captive insurers may wish to consider the following immediate key actions to prepare for the changing tax landscape:

- **Commercial rationale**: Assess the capital or other commercial benefits arising from the arrangements for the insured, captive and the group as a whole.
- **Substance**: Review and, where necessary, remediate operating models to ensure new substance requirements are met and that the risk of creating a deemed taxable presence outside the captive location is mitigated.
- **Transfer pricing**: Review the transfer pricing position of captive arrangements and document, update or revise where appropriate.
- **Engage**: Given the OECD’s further work during 2016/2017 on financial transactions will include captive insurance, it will be important that groups with captive insurers spend time sharing information and insights with the OECD about the industry.

**Detailed discussion**

**Summary of recent developments**

The BEPS project was originally mandated by G20 Finance Ministers in 2013 in response to concerns over the tax affairs of multinational groups. Media attention continues and multinationals as well as governments are coming under pressure to quickly implement legislative changes to target perceived BEPS risks.

The final OECD BEPS reports make it clear that captives are widely regarded as a potential source of profit shifting, with numerous references to captives made in a negative context throughout the documents. Furthermore, the OECD announced in the BEPS reports that further work will be undertaken over the course of 2016 and 2017 to establish specific guidance on the transfer pricing of financial transactions, which includes captive insurance arrangements.

Although the ATA Directive will unlikely be introduced in its present form, the provisions as currently drafted distinguish captive insurers from insurance undertakings with the implication being that groups with captives may have an increased tax burden as compared to those placing risk in the third party insurance market. The ATA Directive refers to Directive 2009/138/EC which applies the EU Solvency II regulatory framework. This defines a “captive undertaking” as “an insurance undertaking, owned either by a financial undertaking other than an insurance or reinsurance undertaking or a group of insurance or reinsurance undertakings within the meaning of Article 212(1)c) or by a non-financial undertaking, the purpose of which is to provide insurance cover exclusively for the risks of the undertaking or undertakings to which it belongs or of an undertaking or undertakings of the group of which it is a member.” Whereas the OECD has not yet defined “captive insurance,” the EU ATA is clearly seeking to apply the regulatory definition.

The application of anti-BEPS guidance and ongoing discussions relating to the ATA Directive are likely to raise concern for groups with captive insurers. At the same time there is likely to be a further increase in scrutiny from global tax authorities as governments implement and enforce legislation in response to the OECD BEPS project.

The OECD’s work has resulted in an extensive rewrite of parts of the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (the Guidelines). These Guidelines, originally published in 1979 and subject to significant amendments over the last 30 years, provide a framework under which global tax authorities may seek to tax intra-group transactions. Under the BEPS project the OECD has now substantially rewritten chapters of the Guidelines with a particular focus on aligning economic outcomes with value creation. These changes will have immediate effect in some jurisdictions.

Additionally, the OECD has issued recommendations for changes to the OECD Model Tax Convention and accordingly double-tax treaties, which broaden the taxing rights of jurisdictions in relation to permanent establishments (PEs) and widen situations when PEs may be deemed to exist. These changes will be effected in 2016 through EU Member States signing up to a multilateral instrument.

**Commercial rationale**

The revised Guidelines now set out criteria for non-recognition of a transaction meaning that tax authorities can now disregard a transaction for tax purposes in certain circumstances. The key question in such an assessment is whether the actual transaction possesses the commercial rationale of arrangements that would be agreed between unrelated parties under comparable economic circumstances.
The final guidance on non-recognition includes a captive insurance example in which a manufacturing company located in an area prone to flooding takes out insurance from an associated company in respect of inventory and plant and machinery risk, in exchange for a premium of 80% of the value of the inventory, property and contents. Given the substantial likelihood of claims, there is no active third party market for the insurance of properties in the area. The Guidelines state that the captive insurance arrangement is “commercially irrational” and there is no market for insurance given the likelihood of significant claims. As such, the guidance concludes that the transaction should not be recognized under the revised Guidelines. In other words, the insurance premium would not be tax deductible for the manufacturing company.

This guidance is disappointing since it is not clear whether it is proposing that the arrangement should not be recognized because third party cover was not available or because the level of the premium is not appropriate. There is therefore a risk that tax authorities could apply this guidance to situations where captive insurers provide cover to group affiliates which would not be available in the third party market. It is not uncommon that captive insurers provide such cover, either because of scale or volume required or because of the market risk appetite. In these cases the captive insurer may provide groups with the ability to more effectively manage global risk through aggregation and diversification, as well as managing risk more efficiently.

In most OECD (and many non-OECD) countries, the Guidelines provide tax authorities with guidance in construing intra-group transactions. It should therefore be noted that the Guidelines are incorporated in domestic tax legislation in many countries and as such these changes could be implemented with immediate effect.

Substance

Much of the OECD work on BEPS has focused on preventing artificial transfers of profits or excessive allocation of capital to entities within a group, particularly those in low tax jurisdictions. It is perceived that inappropriate returns can be achieved in such entities where groups have been able to separate risks, functions and assets through contrived contractual arrangements. In particular, the OECD has looked to better align returns with value creating activities. In other words, profit should arise where there is genuine commercial activity or “substance.” Captive insurers often run outsourced operating models with support from third party brokers and captive managers, and as such there may be challenges around being able to demonstrate the appropriate level of “substance” as envisaged in the Guidelines.

Another feature of the new Guidelines is the increased emphasis on demonstrating control over risk in the entity taking on risk. Although the Guidelines acknowledge that some functions may be outsourced by a risk-taking entity, it is clear that there must be competent and experienced decision makers who have access to information relevant to the decision to take on or lay off a risk. In particular, the final BEPS report in this regard notes that the mere formalizing of the outcome of decision-making (e.g., with a board meeting or signing of documents) would not qualify as “the exercise of a decision-making function sufficient to demonstrate control over risk.” Where an entity cannot demonstrate control over a risk, the return from that risk will be allocated to the group entity that does in fact control the risk and the return to the aforementioned entity will be limited to a risk-free return.

The final OECD BEPS reports also include changes to conditions under which multinationals may be deemed to have a PE in another jurisdiction. The conditions under which and where a PE arises, and the taxing rights of the respective fiscal authorities, have historically been determined under domestic law and governed by the relevant double-tax treaty between states. The international double-tax treaty framework for OECD Member States (and many other states) typically follows the OECD Model Tax Convention. As a result of the BEPS project, the definition of a PE in the OECD Model Tax Convention has been widened. Now this includes not only situations where individuals have an authority to conclude contracts as was previously the case, but also situations where a person “habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification.”

This is particularly relevant for captives where individuals in the group risk function may operate in a capacity of managing or directing the captive. Activities may include procuring or outsourcing services from third-party captive managers or brokers. Even though the captive board of directors may ultimately make decisions, to the extent individuals are dealing with these third-party providers when outside the captive location, even in a group risk role, this could give rise to PE risk.
The final BEPS Action 7 report on PEs also includes changes to a previous exclusion from the PE rules for agents of independent status. The OECD has now changed the definition of an independent agent such that an agent who acts exclusively or almost exclusively for a related entity will no longer be regarded as independent. This could create a PE for captive insurers who use a local third party agent to enter into a contract with a local affiliate.

The final BEPS report relating to controlled foreign company (CFC) rules sets out the building blocks for the design of effective CFC rules. One of these core elements is the definition of CFC income. Specific reference is made to insurance income, which is treated as attributable CFC income where it is derived from contracts or policies with a related party within an unregulated group that also received a deduction for the payment of the insurance premium. Although the ATA Directive will unlikely be introduced in its present form, the CFC provisions as currently drafted appear to depart from the recommendations under the BEPS project. A question and answer document released at the same time as the ATA Directive contains an example relating to captive insurers and how the CFC provisions might apply to tax such arrangements.

Some jurisdictions, such as the UK, already have specific CFC measures relevant for insurance companies while, for others, the decision will need to be made as to whether the CFC measures recommended by the BEPS project should be implemented.

**Transfer pricing**

As described above, the revised Guidelines now include increased guidance on the pricing of transactions to reflect the economic outcomes of value creation. The guidance also now suggests that a two-sided pricing approach is necessary to reflect an arm’s length arrangement for both parties. In the context of captive insurance it will be important to demonstrate that the insured affiliates are paying arm’s length premiums commensurate with the risk transferred, and that the captive insurer is not achieving excessive returns as compared to a stand-alone insurer of a similar size or financial strength.

Furthermore, it will be important to reflect the contributions of other group functions in the transfer pricing of group insurance arrangements. For example, whether other functions in the multinational group provide the captive with the opportunity to access customers (i.e., affiliate companies); if so, whether this market access is compensated appropriately (e.g., as an intermediary function); whether support functions are provided by group risk teams; if so, whether the level of remuneration is appropriate for these functions.

Additionally, it may be possible to consider the revised Guidelines in respect of “synergistic benefits” being economic benefits arising as a result of concerted group actions. For example, where the captive insurer acts as an aggregator for group risk to achieve diversification benefits and/or risk management efficiencies that result in the group as a whole being able to lay off risk into the third party market more economically then such a synergistic benefit should be remunerated accordingly.

Overall, groups with captive insurance arrangements should ensure that transfer pricing documentation is in place to support economic outcomes in line with value creation. In line with the new Guidelines, tax authorities will be looking to see documentation in place detailing the whole insurance value chain within the group, the component functions carrying out activities in respect of that value chain and economic analysis supporting the returns to all counterparties to the arrangements. This documentation should be maintained on an annual basis and in some cases will need to be filed or made available when the insured affiliate files its tax returns.

It will also be important to monitor progress of the OECD’s project during 2016 and 2017 on transfer pricing guidance for financial transactions. As set out above, the OECD has confirmed that this will include captive insurance arrangements. It is not yet clear how the guidance will differ from the areas set out above pertaining to substance, commercial rationale and transfer pricing approaches.

**Engage**

In view of the ongoing work of the OECD and EU in respect of captive insurance, it is vital that the industry makes its voice heard. The industry may want to engage with the OECD Secretariat to help the working party on the regulatory and commercial factors relevant to captives better understand the issues in play.
Implications

It is evident from the final BEPS reports and the EU ATA Directive, notwithstanding the fact that this will unlikely be introduced in its present form, that the OECD and the EU regard captives as a potential source of profit shifting, which may result in local tax authorities taking an increasingly tough stance towards captives.

As countries begin implementing the outcomes from the final BEPS reports and introducing transfer pricing and PE legislation, as well as other anti-avoidance legislation (see, for example, the UK Diverted Profits Tax, and the Australian Multinational Anti-Avoidance Law) captives may be subject to increased scrutiny from tax authorities. Captives should be aware of how the themes outlined in the BEPS project may affect their business, and take action accordingly.

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