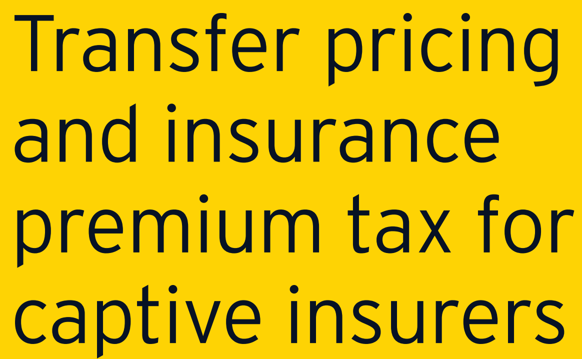

Transfer pricing and insurance premium tax for captive insurers

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1. Executive summary

Captive insurance structures offer a host of possible benefits, including allowing companies to consolidate and manage complex business risks, but the potential underpayment of taxes, or even perceived underpayment of taxes, for a captive can be an unexpected cause of significant loss if handled incorrectly. A company's global reputation could suffer material damage if taxes are unintentionally underpaid in relation to its captive. Those who are unfamiliar with tax regulations for captives might see the underpayment as tax avoidance as has been seen in some of the recent news. The underpayment of tax risk is all the more relevant as the insurance market goes through its "hard" phase and companies are looking to potentially use their captives more effectively to counteract the impact of the hard market.

Transfer pricing principles under Internal Revenue Code (IRC) Section 482, the OECD Guidelines and local country regulations should be used so that the appropriate amount of taxes are paid globally by a multinational enterprise (MNE) and its captive. Transfer pricing supports that prices between related parties (i.e., the captive and respective entities being insured) are arm's length. Tax authorities look at two key factors when assessing a captive's compliance with transfer pricing regulations:

1. Is the premium charged by the captive arm's length (i.e., consistent with pricing in the open market, derived using industry-accepted methods), making the amount that is deducted for tax purposes acceptable?
2. Is the right premium allocated among the entities that benefit from the coverage provided by the captive, allowing the correct tax to be paid by each entity insured by the captive?

These two points are intertwined. If the premium is not arm's length, the deduction taken for the premium payment could be adjusted or rejected altogether. Similarly, if entities aren't allocated an appropriate share of premium, there is a risk that local taxes, including the insurance premium tax (IPT), for the captive may be under/overpaid. There are clear paths, however, to mitigating these risks.

This article provides an overview of (i) transfer pricing for captive insurers, (ii) the interplay between transfer pricing and the various taxes that are due (e.g., IPT) for insurance providers, and (iii) areas of possible risk and ways to potentially manage those risks.

2. Background on IPT and transfer pricing for captives

Overview of transfer pricing

While intragroup and intercompany transactions are very common within consolidated groups and between affiliates, transfer pricing is frequently questioned under tax audit and constitutes one of the more significant sources of tax risk and most frequent controversy issues for most MNEs.[1] Effective transfer pricing that prices intercompany transactions at arm's length may reduce the risk of adjustment and the imposition of penalties. Given that captive insurance is insurance provided by a related party, transactions involving a captive fall squarely within the scope of transfer pricing and are increasingly the subject of global scrutiny.

Transfer pricing is not an area that has previously garnered much attention from MNEs with captives; however, it is becoming a tool that is used more commonly to demonstrate that intercompany premiums paid to a captive are consistent with market rates and, therefore, the premiums paid are deductible. Once premiums are established, transfer pricing also helps to determine which entities should be allocated the premium by identifying the entities that benefit from the policies underwritten by the captive. MNEs should perform both of these analyses on a risk-by-risk basis for all intercompany risks insured by the captive for the benefit of its affiliates.

Overview of insurance premium tax

Insurance companies are subject to a variety of taxes, including IPT, which is a tax levied by governments on the premium charged to an insured entity. In a third-party context, the insurer charges the policyholder for the IPT together with the insurance premium and reflects the IPT in monthly returns that are filed in the relevant jurisdiction of the third-party insurer. Captive insurers also need to pay IPT as an insurance company under IRC Section 831 or local regulations where a company does business. Even if a captive is not licensed in a jurisdiction where risks are insured, the captive may need to self-assess IPT in that jurisdiction. The amount of IPT that an entity owes is based on the total premiums paid in the jurisdiction that imposes IPT.[2]

In the third-party insurance context, the premium paid to a third-party insurer is known and, therefore, the IPT amount due is certain. For a captive that is part of an affiliated group, the full value of the premium may be paid by only one member of the group (e.g., common paymaster company), but the risks of many other members may also be insured. In such a case, an MNE group should use transfer pricing principles to allocate the premium to the MNE group's global members that benefit from the policies. Common MNE practice often allocates premiums as part of the "management fee" or "head office allocation" on a generic allocation metric and ignores if the allocation factor appropriately reflects the business model and the computation of IPT. If this critical step is not undertaken, income tax and IPT may inadvertently be underpaid, leaving the MNE ultimately exposed to tax and reputational risks.

In recent years, tax authorities of several countries have been pursuing taxpayers and, in cases such as Germany, imposing criminal and civil penalties for failure to file IPT returns. The IPT rate of 19%[3] in Germany is significant, but the reputational risk associated with a potential civil (or, in some cases, criminal) investigation for tax fraud makes it imperative for any MNEs with insured global risk to evaluate the extent to which they may have IPT exposure based on their global supply chain.

1 "2021 EY Tax Risk and Controversy Survey: how do you adapt to the changing tax risk landscape?" *ey.com*, 23 February 2021

2 "OECD releases final transfer pricing guidance on financial transactions," *ey.com*, 11 February 2020

3 The IPT rate per country varies, and a country-by-country analysis of the requirements needs to be conducted.

3. Historical risks in captives

Historically, captives were often used to insure "simple" risks such as workers, compensation, property liability, automobile liability and general liability risks. These policies were relatively straightforward to underwrite because they were some of the most common in the open market (i.e., easy to benchmark against third parties) and the beneficiaries of such policies were clearly determinable (e.g., workers' compensation premiums are typically allocated based on headcount). Moreover, those policies often only covered headquarter country risks. With the hardening of the insurance market, however, captives are taking on more abstruse risks such as product liability, cybersecurity and business interruption risk, which are global and more difficult to price and allocate.

Underwriting for these types of risk is more complex; the analysis is often more subjective, as there is less data around historical losses and significant assumptions may have to be used. For example, it is extremely difficult to estimate the probability of product liability loss due to a certain discovery (e.g., cell phone usage leading to cancer). As another example that may hit closer to home, before the COVID-19 pandemic, pricing for business interruption risk was notoriously difficult. While some market comparables existed through flood, fire and wind insurance, many of these failed to capture the scale of a global business interruption due to the pandemic. As a result, open market and related-party pricing for business interruption insurance may not have sufficiently accounted for the full range of claims.

4. Pricing the premium

A transfer pricing analysis allows a company to demonstrate that the premiums charged by its captive are consistent with the tax rules' arm's-length standard and comply with tax definitions of insurance. Given the increased complexity of risks taken on by captives, it is even more important that MNEs conduct a transfer pricing analysis that shows the arm's-length nature of the intercompany premiums are consistent with the tax rules.

The tax courts and governing bodies have relied on transfer pricing to confirm that the premiums are arm's length by reference to third-party insurance pricing and, therefore, are deductible. For example, *Rent-A-Center, Inc. v Commissioner* and other court cases use a transfer pricing analysis to demonstrate that the premiums are arm's length and the arrangement with the captive meets the definition of common notions of insurance. Further, the 2020 OECD Guidance on financial transactions[4] notes that, when risks that are difficult or impossible to get insured in the open market are insured by a captive, the commercial rationality of such insurance may be questioned and the arm's-length pricing of such policies may be more highly scrutinized. All this is in addition to the detailed actuarial work that needs to be done on pricing and reserve assessment.

To undertake an analysis of the arm's-length nature of the premiums, MNEs often rely on the actuary's analysis as a

[4] "Transfer Pricing Guidance on Financial Transactions: Inclusive Framework on BEPS: Actions 4, 8-10," *OECD.org*; accessed 27 September 2021

starting point, but additional work is generally required to verify that the analysis also complies with tax regulations. Using the example of business interruption risk that we noted above, actuaries will have to make significant assumptions when setting the premium to be charged for this risk given the lack of historical data and potential high severity if a claim needs to be paid. At a minimum, to support the arm's-length nature of the premium, MNEs will have to explain the actuarial analysis in a manner in which the tax authorities can understand by demonstrating that the results of the actuarial analysis are also arm's length in nature and that the assumptions of profit margin are consistent with market observations.

In many cases, however, it may be helpful to prepare a simpler transfer pricing analysis that the tax authorities globally can understand based on their experiences in case the premium deduction is challenged. This simpler analysis could be done by using third-party benchmarks to further support that the pricing is consistent with the pricing that would be found in the open market.

5. Allocating the premium

Once the MNE concludes that the premiums are consistent with the arm's-length standard, these premiums may need to be further allocated among the members of the group that benefit from the insurance coverage obtained. Transfer pricing analysis allocates the premium between the entities that benefit from the coverage and forms the basis for calculating IPT due in the relevant jurisdictions. Confirming that the correct tax is paid in each jurisdiction mitigates the risk of scrutiny for the captive both from a compliance and reputational standpoint.

It is important to consider the following when allocating premiums:

- The risk covered by the policy
- The beneficiaries of the insurance (i.e., entities that benefit from the coverage pay for such coverage)
- The global supply chain of the company
- Global transfer pricing policies

With more complex risks, multiple entities could possibly benefit from a single policy at the same time. Returning to the example of business interruption risk, multiple entities throughout a global MNE could be impacted by a business interruption and benefit from the associated insurance policy. The extent to which each entity benefits from a policy's coverage may depend on the group's global supply chain and the general transfer pricing policy to remunerate related-party transactions. For example, an entrepreneur that receives residual profits and losses will be affected disproportionately by the business interrupted compared to entities that are remunerated on a cost-plus basis in which they are paid a fixed return regardless of the profits of the overall business.

With today's increasingly global supply chain and complex global transfer pricing policies, it is rare that an event only impacts one entity and does not have ripple effects throughout a group, which makes this allocation exercise both more challenging and more necessary. For example, if an intermediary manufacturer experiences a fire at its factory, the entity that conducts the final assembly will also have its business interrupted, as it will not have the required intermediary parts. The allocation of the premium should take these factors into consideration to allocate the premium in a way that considers the activities performed by each member of the group, the potential for losses should the insurance not be in place and the global nature of the business. This allocation exercise is significantly more complicated than allocating the premium for a risk such as workers' compensation, which is typically allocated out to the entities based on headcount of the workers covered by the policy.

Many groups allocate their premiums in the same manner that they allocate other back-office service costs like finance or tax — namely by using an accounting-based allocation factor such as revenue. While this approach works for general services performed by the group and may be simpler to operationalize, captive premiums need to be allocated based on each individual risk and the respective beneficiaries. In the example of business interruption risk, allocating premium based on revenue may result in the entrepreneurial entities not bearing their share of the premium despite being the biggest beneficiary in the case of a claim. Further, it would be inappropriate to allocate this risk based on headcount as you would for workers' compensation, as headcount does not align with the benefit an entity might obtain from the insurance policy.

6. IPT

The misallocation of premiums could lead to misreporting of IPT and unintentional over/underpayment of income tax. The risk of tax underpayment in jurisdictions where the MNE operates is significant both from a compliance and reputational standpoint, given an uneducated reader may interpret this to mean the captive is being used to avoid the payment of certain taxes.

Captives are required to self-assess the amount of IPT due and file a tax return in well over 30 jurisdictions that have IPT requirements, including Germany, Belgium, Slovakia, Italy, the UK and Australia. The IPT compliance requirements are strict and often difficult to comply with or follow. In most cases, tax returns need to be filed monthly. While these rules have been in place for a number of years, recent audit activity has resulted in significant tax exposure for some companies. In certain cases, the tax authorities have regarded the failure to file IPT returns as a grossly negligent understatement of taxes or even as intentional tax fraud. The failure to file IPT returns is often discovered during a normal corporate income tax audit. To manage the related tax and other potential risks, MNEs with global insurance policies should verify that they are in compliance with the IPT regulations in applicable jurisdictions.

As described above, transfer pricing can be used to determine an arm's-length allocation of premium to each jurisdiction, and in turn the amount of IPT due can be assessed.

7. Conclusion

A transfer pricing analysis is an important mechanism to demonstrate that the premiums paid to a captive (i) are arm's length and, thus, deductible and (ii) are allocated appropriately to the entities within the global supply chain that benefit from the respective policies. It also can show that the correct amount of tax due, including IPT, is paid in the jurisdictions in which the MNE operates.

This analysis should not be conducted on a one-off basis but instead should be revisited annually, particularly if there are changes to the MNE's business activities, if a restructuring occurs or if there is a change to the MNE's overall transfer pricing policy that would affect the analysis. Due to the complexity of the relevant issues and the constantly changing regulatory environment, a formal transfer pricing analysis should be conducted where possible to help mitigate the risks described above.

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US SCORE no. 14041-211US
2109-3875227
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