



OECD transfer
pricing guidance
on financial
transactions and
the impact for
captive insurers

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Summary and background

The Organisation for Economic Co-operation and Development (OECD) published its Transfer Pricing Guidance on Financial Transactions on 11 February 2020. This long-awaited final guidance follows the previous non-consensus public discussion draft that was released in 2018. It will be included within the OECD Transfer Pricing Guidelines (TPGs) and represents the first time that financing transactions have been specifically included within the TPG.¹

While the report has overarching comments that apply to all intercompany financing arrangements, there is a specific section dedicated to captive insurance and it is this section that is considered further here.

What is “captive insurance” for the purposes of the guidance? Is your captive covered by these rules?

The first section of the guidance sets out that “the term ‘captive insurance’ is intended to refer to an insurance undertaking or entity substantially all of whose insurance business is to provide insurance policies for risks of entities of the multinational group (MNE or MNE group) to which it belongs,” and this includes captive reinsurance through fronting.

What do the rules mean for captive insurers that fall within this definition?

At a high level, the statement that “the principles of accurate delineation of the transaction in Chapter I of the OECD 2017 Transfer Pricing Guidelines (OECD TPG) apply to captive insurance and reinsurance” means that internationally accepted transfer pricing principles are applicable to captives in the same way that they apply to all intragroup transactions. The second section of the guidance covers the circumstances where transactions are not considered to be genuine insurance arrangements. Where the tax authority concludes that the contracts are not genuine insurance contracts, it may conclude that the insurance is performed by another entity in the group or that there is no insurance. This is consistent with guidance elsewhere in the TPG. As a consequence, the guidance concludes that any premiums paid by the captive or profits made by it be taxed elsewhere.

The guidance sets out what indicators of genuine insurance should be, noting that all or substantially all of these factors would be expected to be present in an independent insurer, and thus for the captive arrangements to be respected, they should also be present for the captive insurer.

- ▶ Diversification of pooling of risks is present in the captive insurance.
- ▶ The economic capital position of the entities within the MNE group has improved as a result of diversification and there is therefore a real economic impact for the MNE group as a whole.
- ▶ Both the insurer and any reinsurer are regulated entities with broadly similar regulatory regimes and regulators that require evidence of risk assumption and appropriate capital levels.
- ▶ The insured risk would otherwise be insurable outside the MNE group.
- ▶ The captive has the requisite skills, including investment skills, and experience at its disposal, including employees with senior underwriting expertise.
- ▶ The captive has a real possibility of suffering losses.

It may be challenging to demonstrate some of the expectations regarding diversification and assumption of risks in the absence of capital modeling exercises, or to definitively prove that insured risk would otherwise be insurable outside the MNE group, especially where such risks have been insured within the group for a number of years and represent very specific business risks that may not be commonly found in the external insurance market. The third bullet may apply only to fronting reinsurance arrangements (where the captive reinsures a third-party insurer) and could be seen as implying that special regulatory regimes for captives might not be evidence that the captive is undertaking genuine insurance transactions. It should be remembered that the indicators are just that and an accurate delineation of the transaction using the principles in the TPG may still lead to the conclusion that the captive is undertaking genuine insurance transactions.

Tax authorities pay particular attention to the capability of an enterprise to manage and control the risks it assumes; therefore, the ability of the captive's employees to manage the captive's business should be considered. The guidance recognizes that captives can operate with highly outsourced models as long as the captive's employees perform underwriting and risk control functions. Specifically, the captive employees should have:

- ▶ The capability to make decisions to take on, lay off or decline a risk-bearing opportunity, together with the actual performance of that decision-making function

- ▶ The capability to make decisions on whether and how to respond to the risks associated with the opportunity, together with the actual performance of that decision-making function

This does not necessarily require significant numbers of staff, but the captive should be able to demonstrate that the employees performing the underwriting, risk management and control function have the requisite qualifications and experience and they do more than just “rubber stamp” decisions made elsewhere.

What specific points are considered in terms of pricing of transactions?

Once the initial hurdle has been passed and the captive is recognized by the tax authority as issuing genuine insurance contracts, the third section of the guidance then has detailed analysis on how the pricing of such transactions should be set within multinational groups. This can be broadly split into the following methods:

- ▶ Comparable (CUP) agreements either between two unrelated parties or an internal party and an unrelated party
- ▶ Benchmarked combined ratio
- ▶ Benchmarked return on capital
- ▶ Actuarial pricing

The use of a CUP is uncontroversial and a benchmarked return on the insurer’s capital is the most common pricing method by tax authorities. Benchmarking the captive combined ratio against independent insurers can, however, be more problematic. Experience shows that it is rarely possible to find sufficiently comparable data from independent insurers to perform any meaningful benchmarking exercise.

The section on return on capital requires the captive to have regard to what would be an appropriate level of capital for the risks assumed by the captive. The guidance suggests that a captive may require less capital than an independent insurer with a similar portfolio of risks, which could, if implemented by tax authorities as written, lead to operational challenges for captives, especially in relation to the levels of capital buffer that may be required to reach credit rating equivalence.

Of more use to captive insurers is the recognition that actuarial methods can be an acceptable way of arriving at an arm’s-length price. In our experience, tax authorities have historically been resistant to actuarial pricing and, therefore, having obtained approval in the form of guidance, albeit with caveats, is a welcome development.

The guidance also suggests a novel approach to pricing insurance transactions where a captive’s role is to pool risks to access third-party reinsurance programs. The guidance concludes that risk pooling is only akin to other centralized group functions such as procurement. The example in the guidance suggests this pooling or diversification benefit is not due to the captive itself but due to the MNE having diverse geographic risks, and the benefit should then be passed on to the affiliate companies. This seems to entirely misunderstand the role of captive insurance and the point that an MNE’s group risks can only be diversified or pooled in a licensed, regulated captive insurance company holding sufficient ring-fenced capital. In the absence of a captive insurance company, each of the affiliate companies would need to access the third-party market individually without the benefit of a pooled, diversified book being ceded from a capitalized counterparty. This would result in a higher cost of capital for the third-party insurers, which would impact pricing for the MNE. An accurate delineation of the insurance and reinsurance transactions should recognize the captive’s role in unlocking the capital benefits for the rest of the group. If that includes the assumption and retention of insurance, risk the captive should be entitled to an appropriate reward.

What should captive owners be doing as a result of this guidance from the OECD?

As noted above, this is the first time that the OECD has provided specific guidance in relation to financing transactions, and therefore, captive owners should ensure that the guidance is reviewed in the context of their individual operating business. Specific points to consider include the following:

- ▶ Review the captive insurer/(re)insurer fact pattern vs. the indicators of genuine insurance
- ▶ Review the functions performed by the captive insurer/(re)insurer to ensure that they meet the control of risk criteria and ensure that the entity has the capability to assume the reinsured risks
- ▶ Review the capital structure of the captive insurer/ (re)insurer to ensure that the capital held is adequate but not excessive for the risks assumed
- ▶ Consider whether any actuarial pricing should be adjusted for tax purposes

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Contacts



Jo Ford is a senior manager in the Ernst & Young LLP (UK) EMEIA Financial Services Organization's Transfer Pricing team and is experienced in transfer pricing for over 15 years. Jo has extensive experience in designing and documenting transfer pricing policies with a particular area of focus on the captive insurance market. Jo can be reached at +44 20 7951 3785 or jford2@uk.ey.com.



Martin Powell is a managing director in the Ernst & Young LLP (UK) EMEIA Financial Services Organization's Insurance Sector, focused on UK and international tax matters. Martin spent 10 years as the UK's Tax Authority (HMRC) Lead for Transfer Pricing in the insurance industry. Since joining Ernst & Young LLP in 2017, Martin has provided tax technical resources on a number of captive insurance and general insurance tax matters. Martin can be reached at +44 20 7760 9339 or mpowell@uk.ey.com.



Jenny Coletta is an insurance international tax partner in the Ernst & Young LLP (UK) EMEIA Financial Services Organization's Insurance Sector. Jenny has 20 years of experience of providing international tax advice to insurance and captive insurance companies and leads our Global Insurance Transfer Pricing team and is a member of the EY Global Captive Network as EMEIA lead. Jenny is actively engaged in discussions with the OECD and governments on the OECD BEPS project and is the insurance lead in the Firm's insurance company working group, leading the response to the OECD BEPS project. Jenny was also the Firm's representative in the Government and HMRC insurance working group on Brexit tax issues for the industry. Jenny is a regular presenter on BEPS-related topics at captive industry events. Jenny can be reached at +44 20 7951 5993 or jcoletta@uk.ey.com.

¹ OECD TPG 2017 paragraphs 1.126 and 11.27.