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Guernsey Captives:
Life After Diverted Profits Tax

Forward to a colleague

Groups with captive insurance arrangements are assessing their potential exposures to UK diverted profits tax. But the tax is not the death knell for the Guernsey captive industry.

UK diverted profits tax ("DPT"), which has effect from 1 April 2015, impacts both the UK payer of insurance premiums and the Guernsey captive insurer that receives them. The tax applies at a rate of 25% to "diverted profits" and can apply both to direct insurance and to fronted arrangements. This summary considers the potential liability of the paying company under the charge on "involvement of entities or transactions lacking economic substance" (in sections 80-81 Finance Act 2015).

There is also a potential charge on the captive insurer itself (under section 86) if the arrangements are set up in such a way that an "avoided permanent establishment" of the insurer in the UK is servicing its customers from the UK. Under the usual operating model for Guernsey captive insurers, a DPT charge under section 86 is less likely to apply, and so this aspect is not covered below.

There is an exception for companies within groups with fewer than 250 employees and which have either turnover not exceeding €50m and/or balance sheet total assets not exceeding €43m. Groups that exceed this threshold are currently evaluating their captive insurance arrangements in the light of the tax.

Assessing the DPT position

HMRC's interim draft guidance contains an example of captive insurance arrangements which give rise to diverted profits that are taxable on the UK payer of premiums, and some people have read that as suggesting that all captive arrangements will give rise to DPT. The HMRC example is, however, an extreme one in which there are many years of zero claims experience and no motive other than tax for the insurance. The example also ignores the potential interaction between DPT and the UK Controlled Foreign Companies ("CFC") rules. In practice, it therefore gives groups with Guernsey captives very little guidance on how to evaluate their potential DPT exposure under more normal commercial captive insurance arrangements.

The following paragraphs set out some of the key issues to be considered to determine whether DPT applies.

Is the transaction designed to secure a tax reduction?

DPT potentially applies if, among other conditions, it is reasonable to assume that the insurance from the UK to the Guernsey captive was designed to achieve the tax reduction. It is therefore important to ascertain all the reasons for the arrangements.

These may include, in addition to tax reasons, other commercial reasons such as better risk management, more efficient purchase of cover, capital and regulatory requirements or the ability to place cover not obtainable in the market.

In Guernsey, there are many commercial reasons, which have led to the growth and ongoing success of the captive insurance market including cost efficiencies due to the different capital and regulatory requirements compared to, say, the UK, flexibility and innovation in new products, established expertise both in the business and professional services sector as well as a long standing global reputation.

Where there is no UK or other country CFC tax charge on a group parent it will often be reasonable to assume that tax is one of the reasons for the arrangements. But the legislation also stipulates that "regard must be had to all the circumstances, including any liability for any additional tax that arises directly or indirectly as a consequence of the transaction or transactions" (section 110(9)(a) FA 2015) and so the expected CFC position must also be taken into account. The HMRC guidance recognises this and notes in their interim guidance (at DPT 2310) that where the tax reduction between the UK and foreign parties to a transaction "is matched or exceeded by a CFC charge in the parent company in relation to that provision it's unlikely that that provision would have been designed to achieve a tax reduction".

What, if any, are the "diverted profits"?

Where groups determine that the Guernsey captive arrangements may be a transaction "lacking economic substance" it is necessary to consider what the non-tax reasons for the arrangements are. This is because the non-tax reasons drive the determination of what DPT, if any, is due.

The next step is to hypothesise what alternative related-party transaction, if any, it is just and reasonable to assume would have been made if tax had not been a relevant consideration for any person at any time, and the calculation of the diverted profits, if any, follows from that.

If the UK company would have purchased insurance from a non-UK insurer in any event, there will only be diverted profits if the transfer pricing of the captive arrangements is inadequate. For example, if the captive is writing a compulsory class of business, the most likely alternative to the actual transaction would seem to be that the company would have purchased insurance from another related-party captive insurer. It may be necessary to hypothesise a new captive for this purpose, and the only question then would be whether the group would be likely to set up a captive in the UK or not.

On the other hand, if tax was the only reason for the captive arrangements they will be disregarded and the diverted profits will be calculated as if the insurance was not in place. If the most likely alternative is that there would have been a different, non-insurance related-party transaction the diverted profits will be calculated by reference that instead.

Calculating the DPT liability

If there are diverted profits, tax is charged at 25% on the diverted profits, plus interest from 6 months after the end of the accounting period to the date the charging notice is issued. In calculating the DPT charge, credit is given for tax that is suffered on the same profits by the company or another company, including any UK and/or other country CFC tax that is borne by a parent company on the profits. So in circumstances in which a CFC charge does not take the arrangements out of the tax entirely there can nonetheless be a credit for the CFC charge itself.

Engagement with HMRC

The notification requirements for DPT are wider than the scope of the tax itself, and we expect that all substantial UK groups with captive insurance arrangements will be entering into discussion with HMRC on their arrangements. As noted above, there will be many circumstances in which Guernsey captive arrangements should not give rise to a DPT liability (assuming the transfer pricing is correct), but the analysis is fact specific to each group. All potentially affected groups should therefore carefully consider and document their DPT analysis as a basis for their engagement with the UK tax authorities.

How Deloitte can help

Our specialist tax teams in the UK and Guernsey have a great deal of experience in the captive insurance market and have been supporting a number of captives and captive managers in assessing the impact of the new DPT legislation, documenting the position, engaging with HMRC and developing solutions.

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