Module H Unit 14

FISCAL MATTERS

Purpose

At the end of this unit the participant should be able to demonstrate an understanding as to the type of taxes to which a (re)insurance company may be subject (directly or indirectly) and the administration required to address them.

Assumed knowledge

A basic understanding of the application of insurance premium tax.

Summary of learning outcomes
1. Explain which taxes may impact the operation of a (re)insurance company
2. Recognise that the choice of domicile for a (re)insurer should not be driven solely by taxation considerations
3. Explain the importance of recognising and administering premium taxes
4. Describe the operational and governance regime that needs to be followed by a (re)insurance company in order to meet the Guernsey Economic Substance requirements

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14.0 INTRODUCTION

The tax position of captives and captive owners (and the methods of taxation adopted) are key issues in captive management irrespective of location of the captive and parent.

A great deal of management time can be expended in dealing with taxation issues and it can be a significant draw upon resource across the industry (for captive managers, tax advisors, legal advisers and the clients themselves)

Industry commentators would point out that there has been for a number of years, a disproportionate level of fiscal attention and resource aimed at captive insurance vehicles- especially when they are located in low tax jurisdictions.

Rarely is taxation a priority in setting up a captive. This may not have been as true in the past, when fiscal policy was not as sophisticated and it was legitimately possible to shelter from tax authorities profits generated in the captive. But for the parent of the captive, the tax treatment of the captive will be a consideration of whether to establish the captive, where it is domiciled and the captive's business plan & modus operandi.

Before we can understand the impact of taxation on insurance captive vehicles, it's important to have a basic understanding of the main types of taxation that apply in most jurisdictions.

Tax Overview

Taxation is the 'imposition of compulsory levies on individuals or entities by governments.' Taxes are levied in almost every country of the world, primarily to raise revenue for government expenditures, although they serve other purposes e.g. economic policy such as reducing inflation, imposition on competing imports to local industry.

Types of Taxes

There are two types of taxes namely:

- direct taxes
- indirect taxes.

Examples of Direct Taxes

- Income tax payable on in income from work, employment, or income generated by an asset such as renting property or an investment portfolio

- Corporate tax: tax on corporate profits or gains in values of assets owned by the corporate and

- Wealth tax or capital gains tax; on the sale of an asset which has increased in value. Tax may be charged on the difference between the purchase price and the sale price e.g. a work of art at an auction

Examples of Indirect Taxes

Taxes that are incurred indirectly on consumption, such as sales tax, duty, insurance premium tax (IPT) and value added tax. It is mostly on the areas of Corporation tax and IPT where our focus will be.

Corporate Taxation Profits

Corporation Tax is a tax that is payable from all taxable profits of any company that is based in the country in question. If the company is a multinational and has operations in territories outside its resident domicile, it is increasingly common that the profits generated by those subsidiaries will also fall into the tax net no matter where in the world the profit was generated. Corporation Tax is typically calculated and paid annually based on the 'Corporation Tax accounting period', which is usually the same as the company's financial year.

The phrase ‘no matter where in the world the profit is generated’ is usually applicable to captive vehicles as many of them are established outside the main jurisdiction of its parent and often in low or no tax jurisdictions.

The reason for establishing insurance captives in low tax jurisdictions is often because those jurisdictions have captive friendly insurance/reinsurance legislation and the presence of specialist firms who manage them on behalf of their corporate, or indeed, private owners.

These two issues, international corporate tax and captive insurance, create an interaction that is of importance within the industry and is a key aspect of most captive owners and managers consideration.

It has been explained in earlier units how captives reduce the frictional cost of insurance and, given the same premium and loss experience compared with a traditional market policy, a captive may deliver a profit margin that might otherwise not have been realised given the commercial market’s cost base.

Captives are primarily set up for sound commercial reasons and selection of an offshore domicile is convenient as stated above, from a regulatory and operational viewpoint. As a genuine bona fide insurance operation and assuming fair pricing and true risk transfer, there is no reason why the premiums paid to the captive should not be treated as a taxable expense by the insured, as would any premium paid to a third party insurer.

The ultimate profit, however, would tend to be higher than that which would be achieved by a traditional insurer (because of the different cost bases and pricing models) and when tax is ultimately paid on this new additional profit by the captive’s results being consolidated into the parent company’s taxable income, then this is additional tax captured by the tax authorities and not, as some perceive, a deferral of tax. If the captive had not been formed, any profit would have been earned by an external insurer- and its tax authority benefitted instead.

From a captive owner’s point of view, they should also recognize that the main purpose of the offshore location is not tax avoidance. In some circumstances, there may be some fiscal advantage in being offshore but that now tends to be minimal and generally is tax neutral. Nevertheless, some captive parents might be distracted by the issue and could spend an inordinate amount of time on fiscal structuring to avoid or delay the payment of tax on captive profits. Whilst it can be argued there is nothing wrong with this tax planning, as long as it is legal,, it should be recognized that a corporate can only pay tax on a profit and the profit in the captive is new profit that would not otherwise have been generated.

The bottom line is that, the driving factor, regarding the setting up of a captive, is that it must be commercially attractive. If there are no sound strategic or commercial reasons for the creation of the captive and its profitability depends purely on tax or other fiscal advantage then the supporting feasibility study would not stand up to scrutiny. Tax and fiscal advantage tend to be short term and to obtain these under the guise of a quasi-insurance operation generally does not appeal to responsible captive owners and captive professionals and is likely to be challenged by the regulator.

It is not possible to produce a detailed treatise on tax relative to the various countries of the world. The laws and tax regulations, (some of which we will return to later in this section in some more detail) as they are contemporary versions of many years of tax authority attitudes and fiscal tensions to captive insurance of each country are markedly different. Even when any given tax jurisdiction is considered, the detailed fiscal laws, regulations and rules are so complex and ever changing that it is impossible to include any categoric detail that would be applicable to all. It is up to each parent company to look at its own tax affairs in the light of their particular tax laws along with the help of their professional advisers and to reach their own conclusions. It is more than likely that the chosen captive managers can be of some assistance and will be happy to work with the tax managers of the captive owner but, at the end of the day, the tax implications tend to be at the parent level.

However, there are a number of general rules which are applicable to all and should be considered before the creation of any captive- and it is those that it is intended to review in this chapter. Having reviewed the commercial attractiveness of the captive proposition and reached the conclusion that it is favorable only then should the tax aspects be looked at.

14.2 TAX ISSUES TO CONSIDER IN A FEASIBILITY STUDY

If circumstances were created by the formation of the captive, where the tax position of the captive owners, be they the immediate or the ultimate owners, is made worse than would be the company's tax position, should the captive not be formed? Such a 'negative tax position' could outweigh the perceived commercial advantages. The points that need to be considered are:

- Will the premium paid to the captive be accepted by the owner's tax jurisdiction as a tax deductible expense? It is one thing being taxed on the captive's profit but the insured not having the ability to receive tax relief on the premium paid can, in many circumstances, be a negative aspect and indeed make the concept of the captive impractical.

- Would the premium be deductible if it was paid to a third party insurer? If the answer to this is in the affirmative but the captive position is negative, there may be a mismatch as to the commercial soundness of the captive structure with the way the captive has been set up or its location. Can this be corrected? Seeking a tax advantage as the principal purpose of a captive is unlikely to stand up to scrutiny as a genuine risk transfer transaction.

- Will the captive's underwriting profit or investment profit be taxed at the ultimate parent as opposed to the immediate parent? Equally, could there be a negative aspect because the immediate captive owner is a subsidiary and could this be overcome by changing the shareholding? A case example probably explains this somewhat complex position;

A British subsidiary company wanted to form a captive entirely for their own business and not for the business of any other part of their parent group. They assumed that the captive would fall under UK corporation tax rules or similar and the profit would ultimately come back to the UK to be taxed and then that profit would go up to their ultimate parent. In this particular case, the ultimate parent happened to be a German company and it was a vagary of the German law that their Revenue authorities would look through the activities of any subsidiary to any offshore location and would not allow any tax relief. Thus, whereas the original thought was that the tax paid in the UK would be relieved under the double tax treaty with Germany the actual position was that the company would pay (at the time) 33% tax in the UK plus a further 56% when those profits, which originally emanated from the captive, were consolidated into Germany. It will be appreciated, that a total tax rate of 89% nullified the commercial advantage and created a worse situation for the subsidiary than a traditional placement. Such an outcome might be considered unfair and inequitable, but it can arise due to non-complementary tax rules across jurisdictions even if those jurisdictions have signed up to international tax protocols and agreements.

- If there is a negative tax position, for the above or any other reason, has the captive been set up properly and should anything be changed to eliminate the negative aspects?

In such cases, it is usually the prospective captive manager and the client's tax advisers who would seek to develop the optimum corporate structure and captive business plan to adopt or recommend an alternative captive jurisdiction. As a general rule, licensed insurance managers do not tend to offer tax advice to clients.

14.3 NEUTRAL TAX POSITION

If there is no difference in the tax position of the parent regardless of the creation of an offshore captive, (this is increasingly the case nowadays), then there remains the commercial advantage which was the main reason for forming in the first place.

14.4 POSITIVE TAX POSITION

Ideally, a properly set up captive may provide some tax advantage, however small, to the captive owner. The appropriate points to consider are:

- **Any positive tax position enhances the commercial benefits**. The commercial benefits will result in the creation of additional profit for the parent group and whilst that profit may have to be consolidated into or repatriated to the parent and tax paid, this is a positive aspect in that the profit, even net of tax, is additional profit and delivering added value to the shareholders.

- With a worldwide group, if different tax rates are applicable around the world, this may present an indirect advantage. Insurance premiums can be treated as a tax deductible expense at the local higher rate at a subsidiary and after payment to a fronting company these premiums will ultimately go through to the captive. The underwriting income and the investment income earned on that premium may then be taxed at a lower rate when those profits are consolidated into or remitted to the ultimate parent.

- Some tax advantages is a result of tax deferral. Premiums may be allowed as a tax deductible expense when paid to a captive. The investment income and underwriting income earned will be declared as profit by that captive at the end of the year. In turn the parent company may not be required to remit the tax due until later as in the tax authority may allow an extended deadline date such as 18 months later.

- The claim/IBNR reserve provision also tends to defer recognition of profit. On the assumption that case and IBNR reserves in the captive are justifiable and whilst they may be conservatively calculated and ultimately prove to be more than required, the difference ought not to be too significant.

- Unearned premium reserves (UPR) can defer income for long term type of business that requires premium to be earned over an extended period e.g. latent defects or warranty insurance which might be earned over eight to ten years. The parent will have treated the full premium as an expense upon payment, but the captive may treat this as underwriting income over the period of cover and, to that extent the underwriting profit on that income will be deferred. It should be noted that the investment income on such unearned premium usually cannot be deferred and typically is taken to profit each year.

14.5 TAX AND COMMERCIAL REASONS FOR A CAPTIVE

To reiterate previous units, discussing commercial advantages of a captive - captives continue to be formed in many jurisdictions for the reasons set out below:

- **To centralize the risk management of the group**. Whilst this can be done without the creation of a captive, there is no doubt that a group owned insurance company, possibly with shareholdings from some of the larger subsidiaries, can act as a very useful focal point. Some groups use the captive profits to fund risk management initiatives throughout that group.

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- **To create a tailor made group insurance policy**. A worldwide fronting arrangement with the risks going through to a captive can have a difference in conditions policy overlying it, providing a common cover to all subsidiaries which might not be available under individual insurances. Furthermore, such a fronting arrangement enables the cover to be more easily controlled.

- **The risk retention policy of a group can be centralized**. Without a captive the risk bearing ability of the group will be limited to the capability each subsidiary has to carry a deductible. The captive increases retention of such deductibles to a group level.

- **Centralized information and accounting procedures**, in so far as they relate to insurance, can be facilitated by a captive. Where the insurance covers iare dealt with individually by each subsidiary, any inquiries from the group risk management department will be answered by a variety of different types of broker schedules with varying levels of omissions of information. A centralized insurance programme with a captive involved provides consolidated and comprehensive underwriting and cost information flow to the parent.

- **The captive gives the parent direct access to the reinsurance market**. This enables risk transfer to be purchased at lower cost, eliminating, the purchase of expensive and unnecessary 'money' swapping primary policies for burning cost expense.

- The risks can be pooled over the group. There may well be exposures that each subsidiary needs to insure but the group is well able to carry the risk itself and the captive enables this to be achieved.

- The whole insurance operation tends to become more efficient. The elimination of a large part of the administrative costs of the traditional market translates into profit for the captive owner and lower premium costs for the insured. In addition to this, the cost of using intermediaries can be reduced in that a large part of an insurance broker's work is related to the placing of the risk: if that is placed with a captive, complexity could well be reduced enabling reduced brokerage fees to be negotiated.

- Should the group's claims history be better than the market average immediate advantage is secured under a captive arrangement instead of being charged an average market price to subsidise other clients of the traditional market.

- Being, in effect, a sophisticated means of carrying one's own risk, a captive facilitates better management of the group claims. The group, through the captive, can exert greater control of the claim process and can make this a more efficient process. More importantly the group becomes immediately aware of claim trends and can direct risk management resources to where most needed thereby reducing claim levels and ultimate insurance cost.

- A captive provides the means to insure what is otherwise uninsurable. This may well enable the parent group to move into new businesses in which it might otherwise not wish to participate, because it is able to protect itself over time and spread over a period the risk of a single loss in one year that might have adverse effects on its balance sheet.

- A captive enables the parent to protect itself against those risks where the insurance market provides an inadequate level of cover or where the costs are exorbitant. The net cost to the parent group will end up as the cost of claims plus the expenses of the captive but less the investment income on allowable premiums.

- Self-insurance without a captive vehicle presents a number of challenges over a worldwide group and cannot achieve the majority of the commercial advantages described.

- A captive creates a new profit centre, collecting all the expense reductions, cash flow and surpluses from ‘uninsurable’ risk. The ultimate total profit is, of course, taxable when remitted back as dividend to the parent.

14.6 TAX CONSEQUENCES TO BE INVESTIGATED

As is clear from the example quoted relative to negative tax consequences, the immediate parent or a subsidiary cannot just look at its own individual tax position where a captive is concerned. It should view the totality of the situation from the point of view of the ultimate parent group, the captive parent, the insured, the captive itself and the source of investment income, as follows:

14.6.1 Country of ultimate parent

It is necessary to examine the tax status of the ultimate parent group. Are economic /substance (minimum levels of work carried out in the captive domicile) rules applicable and is the captive domicile on any black lists of territories? Can the Revenue authorities in the parent domicile ‘look through’ to ultimate subsidiaries of subsidiaries and, in effect, lift the corporate veil? What is the tax treatment of a distribution of profit from the captive? Would it change if a different routing or shareholding was used?

14.6.2 Country of immediate parent

Some subsidiaries are large enough and independent of group control to have their own captive. They may be perfectly satisfied as to the tax position between the captive and themselves but would a negative position be created when those profits are reported up stream to the ultimate parent of the group? Might there be advantage in having the captive owned by one of the non-operational or holding companies within the group?

14.6.3 Country of the insured

- Will premiums to the captive be a tax deductible expenses as though paid to a third party insurer?

- Are the premium rates developed at arm’s length? Are they competitive in the local market?

- Are there any local premium taxes that might increase if a captive is used? An example is the different rates of FET (Federal Excise Tax) if premiums are paid to a non-US entity

- Does the arrangement constitute a genuine transfer of risk between the insured and the captive? Will it be acceptable by the auditors and the Revenue Service as an insurance transaction?

14.6.4 Country of the captive

- Will there be any tax payable locally on captive profit? Is this at a higher rate than would be paid by the parent? Can the tax paid be rebated or offset on payment of dividends to the parent either under double tax treaties or by unilateral relief?

- Are there premium taxes on the inward movement of premium in the captive domicile that do not apply in the domicile of the insured?

- Are there any withholding taxes on dividends between the captive domicile and the country of the insured, the immediate parent or the ultimate parent?

14.6.5 Country of the source of investment income

A captive may not wish to limit itself to investing its assets by engaging investment managers or purchasing investments available in its domicile. Under its investment policy it may be able to secure income from a variety of investment sources. Could there be any withholding taxes or other irrecoverable deductions taken from the investment income?

Having looked at the individual consequences in the above five categories, an overall review may be required to see how any tax consequences interrelate over the various countries involved. Again, because of individual circumstances, it cannot be claimed that the above is an exhaustive list of points or questions but rather act as are 'aide memoire' suggestions that can be taken up with tax advisers.

14.7 TAX ESSENTIALS

It is suggested, again without being an exhaustive list that the following are not just desirable but are key criteria in any captive operation.

- MUST be set up as a bona fide insurance operation.
- MUST have adequate capitalization to meet its perceived obligations of the business plan.
- MUST have adequate liquidity to meet its expenses and potential claim payment requirements.
- MUST consider appropriate reinsurance to protect its capital and reserves on an individual risk and/or aggregate basis as appropriate.
- MUST implement a process of risk acceptance between itself and the fronting company or itself and the parent.
- MUST have an appropriate spread of risk albeit this may be within a single class of business. A captive created solely to write a single high vertical exposure is not normally a compelling business case.
- MUST not be able to be demonstrate it is not a 'money box'. As a bona fide operation it must issue appropriate insurance contracts and pay claims under those contacts.
- MUST operate at arm's length with those parent risk management personnel involved, taking care that decisions on behalf of the captive are made by the captive board (or delegated to the insurance manager)except in the captive domicile.
- MUST operate independently of the parent. Whilst its formation is to assist the parent group, the captive board must nevertheless make its own independent insurance decisions.
- MUST have its own board of directors who must meet regularly and can evidence making their own decisions and to oversee the management of the company.

A captive fulfilling these essentials should have fewer challenges in addressing any tax authority's queries. See below regarding current tax rules and regulations

14.8 INSURANCE PREMIUM TAX

Most countries of the world have enacted insurance premium taxes of one form or another. These can be low, such as the 1% or 4% Federal Excise Tax in the US to as high as 22% in some EU countries. With the advent of insurance premium taxes in the UK a few years ago, it was suggested that this could well inhibit the creation of captives. This was not so. Where a company is diverting insurance premium from the traditional market to its captive then the situation is no different in that the IPT due will be the same. As the captive develops, it may be decided to reduce the premium to reflect superior loss experience, which, whilst reducing the profit, will equally have the effect of reducing the cost of IPT.

However, the question of the inhibiting nature of IPT was really raised relative to those exposures which were not traditionally insured but which it was now desired to put the risks into a captive, such as financial covers and others in the uninsurable risk category or merely where the parent decided to turn any deductible funding arrangement into an insurance arrangement.

It is suggested that provided the IPT is less than the annual corporate tax, it still makes sense to insure using a captive. Where there is a corporate tax rate of, say 35%, the parent will pay a premium of 100 on which it will secure a tax deduction of 35. So, for a net cost of 65 to the parent the captive will receive 100 in premium to meet its claim obligations and may be able to establish an IBNR provision to that amount. In these circumstances, the parent derives a benefit of 35 compared to no insurance at all. If a 10% IPT was introduced the premium to be paid by the parent would then be 110 upon which it would still obtain the 35% tax relief and thus the net cost would be 75, with the captive still receiving a premium of 100. The benefit is reduced but will still be 25 and until such time as IPT exceeds the 35%, in this example, it may be advantageous to have an insurance policy rather than to self-fund the risk.

Where a parental deductible funding arrangement is transferred to a captive under an insurance policy, IPT will then be payable, effectively increasing the cost. Against this, however, the parent obtains tax relief on premiums and the captive has the ability, as a bona fides insurer, to maintain case and IBNR reserves far in excess of those allowed to the parent which may be limited to claims to be paid imminently. The difference (and the effective earlier tax allowance on such reserves) may well give an advantage exceeding the cost of the IPT.

14.9 THE CURRENT TAX ISSUES THAT IMPACT CAPTIVES.

This detailed section provides coverage of the main current issues that reflect tax matters as they relate to captive insurance. The content is mostly for reference only and further reading is recommended.

Political and public pressure on multinationals for increased tax transparency has gained momentum and has resulted in an extensive and complex reporting framework which seeks to examine and assess every aspect of an offshore company which naturally includes captive insurers in terms of company status, assets, management, ownership and profits.

Typically, the captive insurance model is effected through the establishment of a separate insurance company or a protected cell in a PCC facility. Most are sited offshore, in jurisdictions with suitable captive friendly regulatory regimes. It’s usually the same territories that also offer tax advantages for a multitude of different entities and structures, be they funds, trusts, banks or captive insurers. In many cases when setting up a captive, the tax advantages may be the final issue considered because market hardening or inability to obtain cover in the market could be the driving factors for setting up an insurance captive. Nevertheless, most prospective or intended captive owners will have had to research the unavoidable taxation/fiscal issues during the feasibility phase.

From a holistic perspective, the key issues regarding captive corporate tax matters can best be understood by assessing how taxation from any known source could impact the captive’s ability to function or fulfil its objectives.

A captive's, (wholly owned by a non-insurance group), purpose is to retain risk and mitigate the external cost of risk transfer. The income is naturally derived from their parent group and other subsidiaries which can appear on the surface to tax authorities as a means of profit shifting to lower tax regimes. Therefore, it's no surprise that they come under scrutiny from their parent company tax authorities from time to time.

In addition to the level of capital deployed and the commerciality of the premiums paid, relevant tax authorities would also look to scrutinise the level of management resource engaged, especially if the management is outsourced, and to what extent parent company risk management personnel provide support & direction

The below topics are somewhat complex and technical and it is acceptable for captive practitioners to understand the fundamentals rather than an in depth knowledge. These matters are usually left to professional tax advisers to present updates and proposals to the captive board as required.

- Controlled Foreign Companies (CFC)
- Diverted Profits Tax (DPT)
- OECD Transfer Pricing
- Base Erosion & Profit Sharing (BEPS)
- Economic Substance/ Core Income Generating Activities (CIGA)

Controlled Foreign Companies (CFC) Overview

- The profits of UK owned overseas subsidiaries may be subject to UK corporation tax under CFC rules.
- A CFC is a company which is resident outside the UK, but controlled by UK residents.
- The profits of a CFC are attributed to UK companies in accordance with their interest in the CFC (whether direct or indirect). These profits are then subject to an amount of tax equivalent to corporation tax, with a credit for a proportion of any overseas tax paid by the subsidiary

.

- A tax arises only if the UK Company has an interest of at least 25% in the subsidiary. (Most parent companies with captives will hold 100% interest.)
- Key issues to consider under these rules include what evidence is there of a contractual relationship with the UK parent and are the premiums paid proportionate to the risks?
- In addition, is there evidence of substance and mind & management control within the domicile of the captive? Is there significant control of the captive in the UK (including decisions being made) that might undermine the captive's local domicile tax status
- Special rules apply to offshore funds, insurance companies and companies which hold shares in a CFC.

Gateway

- CFC rules only apply **if profits pass through a so called 'gateway'**.
- An 'attribution of profits' will only be required if there are arrangements to reduce or eliminate UK tax, and the profits of the subsidiary are increased as a result.
- There is no 'attribution of profits' required if:
    - no assets or risks are managed by connected parties in the UK;

  - any assets or risks which are managed by connected parties in the UK could be replaced by unconnected parties; or
  - the subsidiary holds assets or risks for bona fide commercial purposes, and not for the purpose of avoiding tax.

Exemptions

In addition to the gateway, there are several exemptions:

- Low profits: this exemption applies where the accounting profits of the subsidiary are not more than £50,000, or not more than £500,000 provided non-trading income is not more than £50,000.
- Low profit margin: this exemption applies where accounting profits are less than 10% of operating expenditure.
- High tax: the exemption applies if the local tax paid is at least 75% of the UK corporation tax which would have been paid in the UK on the same profits.
- Exempt period: a CFC is exempt for the 12 months after it first becomes a CFC

Attributable profits

- Where a CFC does not satisfy an exemption, its profits are attributed to UK companies in accordance with their share in the CFC.

- Attributable profits are those which arise from a ‘significant people function’ (SPF) or a ‘key entrepreneurial risk-taking function’ which is in the UK. The profits are calculated in accordance with the Organisation for Economic Co-operation and Development’s 2010 Report on the Attribution of Profits to Permanent Establishments.

There are exclusions for certain types of income:

- All trading profits are excluded from an attribution, provided certain conditions are satisfied. For example, the CFC must have local premises and derive no more than 20% of its income or management cost from UK residents.

Diverted Profits Tax

The diverted profits tax is a UK tax targeting profits considered to have been diverted from the UK, applicable from 1 April 2015. The tax was introduced as part of anti-avoidance legislation in response to OECD BEPS Action 7 and Actions 8-10

The tax can apply under the following circumstances;

- If there are either transactions in the global supply chain involving low-tax entities lacking economic substance, or arrangements which have a main purpose of avoiding a UK corporation tax charge
- At the time the tax was introduced, The Chancellor stated that the new measure would target "multinationals that use artificial arrangements to divert profits overseas in order to avoid UK tax"
- The tax enables HM Revenue & Customs (HMRC) to re-characterize the supply chain of affected multinational groups and re-compute the profits that, in its view, it is ‘just and reasonable’ to assume would have been earned in the UK and subject to UK corporation tax, had the supply chain not been designed or arranged with a level of purpose to secure group tax efficiencies.
- The DPT will be charged at the rate of 25% on those diverted profits

- A company must pay the tax before it can make substantive representations to HMRC or appeal against an assessment on the merits to the Tax Tribunal.

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 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 (Dixons) and the group’s insurance subsidiary in the Isle of Man.

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’.

OECD Transfer Pricing

The revised OECD Transfer Pricing Guidelines issued in July 2017 included an example on captives.

In July 2018, the OECD issued a Public Discussion Draft with respect to Financial Transactions which included a section on captive insurance. In February 2020, a final version of this report, “Transfer Pricing Guidance on Financial Transactions” was released, which continued to include material on captives and formed a new section of the OECD Guidelines. Concurrently, there has been an increasing number of tax audits of captives, and in some countries, these have resulted in the matter being referred to the courts. Some of these cases have related to small entities or private clients as an extension of wealth management which left certain aspects open to scrutiny as to whether there was true risk transfer or not.

Per paragraph 10.199 of the guidance, in order for the transaction to be regarded as a genuine transaction of insurance, the following criteria must be met:

- There is diversification and pooling of risk in the captive insurance;
- The economic capital position of the entities within the MNE group (any group that has two or more companies in different jurisdictions) has improved as a result of diversification and there is therefore a real economic impact for the MNE group as a whole;
- Both the captive insurance and any reinsurer are regulated entities with broadly similar regulatory regimes with regulators that require evidence of risk assumption and appropriate capital levels;
- The captive has the requisite skills, including investment skills, and experience at its disposal;
- The captive has a real possibility of suffering losses

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Base Erosion & Profit Shifting (BEPS)

The background to BEPS is outlined by the OECD as follows;

Base Erosion and Profit Shifting (BEPS) refers to tax planning strategies used by multinational enterprises that exploit gaps and mismatches in tax rules to avoid paying tax. Developing countries' higher reliance on corporate income tax means they suffer from BEPS disproportionately. BEPS practices cost countries USD 100-240 billion in lost revenue annually. Working together within the OECD/G20 Inclusive Framework on BEPS, 139 countries and jurisdictions are collaborating on the implementation of 15 measures to tackle tax avoidance, improve the coherence of international tax rules and ensure a more transparent tax environment.'

BEPS refers to tax planning strategies that exploit gaps and mismatches in tax rules to artificially shift profits to low or no-tax locations where there is little or no economic activity. Although some of the schemes that have been used are illegal, most are not. International businesses can operate across borders and use BEPS to gain a competitive advantage over enterprises that operate at a domestic level.

BEPS is of major significance particularly for developing countries due to their heavy reliance on corporate income tax from multinational enterprises.

Developed in the context of the OECD/G20 BEPS Project, the 15 actions (as set out on the OECD website) equip governments with domestic and international rules and instruments to address tax avoidance, ensuring that profits are taxed where economic activities generating the profits are performed and where value is created.

Examples of the 15 Actions are;

- Tax Challenges Arising from Digitisation
- Controlled Foreign Companies
- Transfer Pricing
- Substance Rules

Economic Substance

The leading countries of the G20, including the US and the EU, have set out in recent years to address the actual activities in certain jurisdictions to determine whether such jurisdictions could demonstrate substance in the activities that were presumed to take place in that jurisdiction. The requirement was that a territory should not facilitate offshore structures or arrangements aimed at attracting profits which do not reflect real economic substance".

This represents a new criterion, which the Code Group refers to as the '2.2' requirements. In the context of this screening process, the Tax Code Group concluded that certain jurisdictions did not have a "legal substance requirement for entities doing business in or through the jurisdiction". The Code Group were concerned that this perceived lack of legal economic substance requirement "increases the risk that profits registered in a jurisdiction are not commensurate with economic activities and substantial economic presence".

On the basis of this assessment, the EU proposed including identified offshore jurisdictions on a new list of non-co-operating jurisdictions unless they agreed to introduce changes aimed at evidencing real economic activity and substance for relevant businesses within the required time frame.

With this in mind, the legislation requires certain companies/partnerships to demonstrate they have substance by:

- The relevant activities being directed and managed in the jurisdiction;
- Conducting Core Income Generating Activities ("CIGA") in the jurisdiction; and
- There being adequate people, premises and expenditure in the jurisdiction.

Please refer to the appendices Unit 14 for a guide to Guernsey's requirements for Economic Substance.

These substance requirements apply to the following categories of geographically mobile financial and other service activities (the "relevant activities"), identified by the OECD's Forum on Harmful Tax Practices:

- Banking;
- Insurance;
- Shipping;
- Fund Management (this does not include companies/partnerships that are Collective
- Investment Vehicles unless they are a self-managed fund);
- Financing & leasing;
- Headquarters;
- Distribution and service centres;
- Holding Body (a pure equity holding body); and
- Intellectual Property (for which there are specific requirements in high-risk scenarios).

All tax resident companies will be required to provide more information in their tax returns to ensure the above activities can be identified. Partnerships will also be required to register and file an annual tax return to ensure the above activities can be identified.

14.10 TAX CONCLUSIONS

The tax position relative to captives can be broken down into three parts:

i) Create the captive as a bona fide insurance operation and operate on an arm's length basis

ii) Only form a captive for sound commercial reasons

iii) Tax can only be paid on a profit and that profit is in addition to the profit otherwise earned by the group. The fact that tax is paid on that profit puts the captive in exactly the same position as the parent group in its core activity.

Nevertheless, so long as captives are established in low or no tax jurisdictions, the parent company's domicile tax authority will inevitably perceive the captive as an 'entity of interest' and there is little doubt that the captive will be under ongoing scrutiny or have to undergo a test of substance along with audit of its operating and governance practices. It is for this reason that a number of captive owners have decided to move the tax residency of the captive to that of the parent, thereby removing any argument as to the fiscal motive for establishing the captive. However, this creates operating and governance challenges as the captive is still regulated in the captive domicile whilst being a tax payer elsewhere. Care needs to be taken to ensure the appropriate functions and decision making are carried out in the correct jurisdiction.

14.11 CAVEAT

This Module has been written to apply to as broad a base of captives as possible but tax rules differ between countries and are constantly evolving. Accordingly, not all of the above analysis apply to the same extent, if at all, to all captive situations.

Tax rules change frequently. This Module outlines the key drivers currently impacting on captives from various tax authority and super governmental institutions One trend that is occurring is that all territorial tax regimes are slowly but surely eliminating what tax advantages remain from use of a captive and some may reduce the financial advantages. But rarely is an adverse tax position created.

Self-test questions
Answering these questions will remind the participant as to what has been learnt. Once completed, please check your answers against the relevant text. 1. What are some possible negative tax aspects of establishing a captive insurance company? 2. Provide details of three tax essentials for a (re)insurance company? 3. Why is it important for a Guernsey (re)insurer to accept (and remit any associated payments) in respect of premium taxes imposed by other countries? 4. What are the Core Income Generating Activities of a Guernsey (re)insurance company? 5. Where should underwriting decisions of a Guernsey (re)insurer take place and why?

Summary of learning outcomes
1. Explain which taxes may impact the operation of a (re)insurance company
2. Recognise that the choice of domicile for a (re)insurer should not be driven solely by taxation considerations
3. Explain the importance of recognising and administering premium taxes
4. Describe the operational and governance regime that needs to be followed by a (re)insurance company in order to meet the Guernsey Economic Substance requirements