Addressing the 2013 OECD Action Plan on Base Erosion and Profit Shifting

Guidance for Captive Owners and Managers

Captive Insurance Companies Association

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Foreword

In this age of a global economy, more and more captives are insuring their parents' worldwide business risks and as a result they face extraordinary challenges. Keeping track of the myriad of regulations and tax compliance requirements in a multitude of countries can give rise to a major headache for the person responsible for managing a multinational enterprise's (MNE's) captive. Defending intercompany transfer pricing perhaps causes the greatest headache of all. As cross border transactions have grown, tax authorities worldwide have increased their scrutiny of MNEs' intercompany transfer pricing policies and procedures. Most MNEs now have separate transfer pricing departments that in many cases are larger than the MNE's tax department. Business problems associated with transfer pricing are here to stay and it is essential that an executive responsible for managing the MNE's captive stay current on the subject.

While it is not possible to cover every aspect of transfer pricing affecting the management of captives in this paper, we hope that it will be a valuable resource and assist those responsible for managing captives in understanding this global phenomenon.

Sincerely,

Chair, CICA Transfer Pricing Work Group

Executive Summary

The Captive Insurance Companies Association (CICA) has created this paper to provide guidance for captive owners and captive managers to help them address a range of transfer pricing issues and the coherence, substance and transparency required by the Organization for Economic Cooperation and Development's (OECD's) Action Plan for Base Erosion and Profit Shifting (BEPS).

Complying with OECD's Action Plan will require complete transparency and coherence between countries that presents many challenges. While the OECD is trying to achieve tax harmonization, its member countries are striving to attract international business to their shores. It is likely these countries will continue to adopt policies to support their own economic advantage making it difficult to achieve consensus. However, this lack of agreement will not deter OECD's pursuit of preferential tax regimes. When creating and managing a captive it is important to clearly establish that the reasons for forming the captive in its chosen domicile should be not based on tax minimization opportunities.

Detailed review and gathering of information for this paper brought to light the following:

- Transfer pricing regulations in the United States and among OECD member countries already require captive owners to demonstrate that their insurance premiums are determined in line with the arm's length-standard, and their transactions are consistent with third-party activities within the captive insurance industry.
- Captives are an integral part of the "enterprise risk management" of multinational enterprises (MNEs). And, captives are the only tool available to MNEs to manage otherwise uninsured risk exposure in a formalized and regulated way.
- Captives allow MNEs to reinsure risks directly to the reinsurance market (which is not possible without captive involvement). This makes it possible for MNEs to access the higher level of capacity they need to protect their risks.
- Captives are managed by personnel with advanced knowledge, training and industry-approved certifications. This complies with the OECD's requirements that transactions undertaken must be able to establish economic substance and that the people who have the knowledge, authority and ability to control the company, and the risks it accepts, are responsible for the transactions.
- The information captives are required to disclose in regulatory filings upon formation and during their operation, combined with their financial and tax compliance reporting, is substantial. Significant and consistent documentation standards and practice could assist a tax administrator in more efficiently assessing tax compliance and perhaps alleviate some of the potential misunderstandings of the captive's operations.
- Establishing a formal documentation process will increase transparency. Clearly outlining how the captive has considered the arm's-length concept, use of educated third-party service providers, sound actuarial techniques and significant federal and state regulatory oversight will prove necessary as part of due diligence to comply with IRS, OECD and other foreign regulatory requirements.
- Current tax codes in the United States (US) address concerns related to transactions with foreign entities with ties to US shareholders. Many foreign captives insuring US risks have or should consider the Internal Revenue Code Section 953(d) election to avoid complexity and costly expense for complying with controlled foreign corporation rules, which are designed to help prevent some of the same concerns raised by the OECD.

I. Why the OECD Targeted Base Erosion and Profit Shifting (BEPS)

How the OECD was Created

The first cooperation-focused organization, the Organization for European Economic Cooperation (OEEC), comprised of 18 countries, was established in 1948 to run the US-financed Marshall Plan for reconstruction of a continent ravaged by war. Later, after the rise of the North Atlantic Treaty Organization (NATO), Canada and the United States joined OEEC members in signing a new OECD Convention in December 1960. The current Organization for Economic Cooperation and Development (OECD) was officially created September 30, 1961, when the Convention entered into force. Today, 34 member countries participate in the OECD.

OECD Mission

The mission of the OECD is to promote policies that will improve the economic and social well-being of people around the world. One of its goals is to ensure tax harmonization, a term usually used to refer to the process of removing fiscal barriers and discrepancies between tax systems.

Why the Emphasis on Base Erosion and Profit Shifting (BEPS)?

The rapid growth of international trade has created substantial problems for OECD member-countries. While intercompany transactions are an everyday requisite for the vast majority of multinational enterprises (MNEs), OECD member-governments have found them challenging to regulate and difficult to tax. In an attempt to reduce deficits in their national budgets, OECD members have attacked MNEs for structuring their operations in a manner to avoid paying their fair share of taxes. The term "transfer pricing" was created as a reference for everyday inter-company transactions and mistakenly linked with the concepts of "tax shelters" and "tax evasion".

The OECD sees transfer pricing as a soft target with the potential to produce very large increases in tax revenues and views captives, even though they represent only a small portion of the overall universe of transfer pricing, as a vehicle for abuse. The lack of regulations for determining the right transfer price for any kind of international transaction within a group of companies leaves room for significant disagreement. This is particularly the case within captives where determining the appropriate premium payable by a MNE to its captive may be difficult.

As a result, the OECD has issued guidelines, directives and published papers on transfer pricing, one which culminated in a report titled "Base Erosion and Profit Shifting" (BEPS) issued in 2013.

BEPS Report

The OECD believes that BEPS constitutes a serious risk to tax revenues of member countries. In its 2013 BEPS report, the OECD identified transfer pricing as one of the major pressure areas, stating "transfer pricing, particularly in relation to the shifting of risks and intangibles, artificial splitting of ownership of assets between legal entities, and transactions between related-party entities that would rarely take place between independent entities" are particularly troublesome.

Along with transfer pricing, the report listed five additional pressure areas to be addressed including "Tax treatment of related-party debt financing, captive insurance and other intra-group transactions". The report

inferred that MNEs are using captives as a vehicle of tax avoidance by shifting profits from highly taxed countries to those with low or no income taxes, and this requires greater transparency and oversight.

Lastly, the report raised the question of how risk is actually distributed among members of MNEs and examined the economic substance of transactions. In particular, the OECD questioned the managerial capacity to control risk, the financial capacity of the arrangement to bear risk and whether any indemnity payment should be made when risk is shifted between group members.

OECD's Action Plan to Combat BEPS

The OECD continued its original course and issued an Action Plan to combat BEPS that listed 15 specific actions (see Appendix 1).

The basis of the Action Plan is "taxation is at the core of a country's sovereignty". When designing their domestic tax rules, sovereign states may not take into account the effect of other countries' rules. While international standards have sought to address this issue, gaps remain, causing both double taxation and the opportunity of BEPS. The OECD believes these anomalies must be addressed to restore both source and residence taxation where cross-border income would otherwise go untaxed, or taxed at very low rates. In the area of transfer pricing, the OECD actions are specifically designed to provide countries with the opportunity and capabilities to better align their rights to tax with economic substance and activity. The OECD's proposed actions seek to put greater emphasis on value creation than formulary apportionment of profits.

Summary — Complying with the OECD's Action Plan will require complete transparency and coherence between countries. It is essential that captives prepare to meet the requirements of the ever increasing information required.

This paper is meant to provide guidance for captive owners and captive managers to help them address a range of transfer pricing issues and the coherence, substance and transparency required by the OECD's Action Plan.

II. The History of Captives and Their Primary Role in Risk Management

In Action 5 the OECD is requiring compulsory spontaneous exchange of information with "preferential tax regimes". The offshore domiciles in which many captives have been formed are considered by the OECD to be preferential tax regimes. To address this issue it is important to document the non-tax reasons for forming an offshore captive.

Captive Insurance Was Developed to Meet Business Needs Not Addressed by Traditional Insurance

The idea of establishing a wholly owned insurance subsidiary as an alternative risk transfer vehicle resulted from the failure of traditional insurance providers to deliver products their business customers needed. Multinational enterprises (MNEs) found it difficult to secure needed coverage at affordable premiums. In theory, each captive company would insure only the parent's risk and therefore would require less capital to offset future losses than a commercial insurance company that covered multiple client risks.

At first captives grew slowly when traditional insurance regulators in the United States (US), United Kingdom (UK) and many other European countries didn't recognize the controlled risks of a captive would result in less exposure to loss. To be licensed, captives were required to have the same level of capital as traditional insurance companies, which made it prohibitively expensive to form a captive.

A series of developments including the ability to form and manage captives for international clients from an offshore location (Bermuda) in the 1960's followed by a hardening insurance market in the 1970's helped spur the development of captives.

Initially the major international brokers and large insurance groups opposed the captive insurance concept but their continued growth forced a change of heart.

Captive Industry Development Timeline

Time	Action
1700s	• References indicate mutual insurance companies began forming in England to provide insurance to the shipping industry.
1800s	• The first American captives (mutuals) were formed by textile manufacturers in response to high fire insurance rates of that time period.
1860	• A group of London merchants formed their own insurance company called Commercial Union in response to increased insurance rates in 1860.
1920's and 1930's	• Several major companies, including British Petroleum and Unilever in the UK and Lufthansa in Germany, formed their own insurance companies. • In 1935 the first US captive, likely the Mahoning Insurance Company, was established by the Youngstown Sheet & Tube Company. They wrote a single, all-lines policy with Lloyd's of London when rigid insurance laws prohibited Youngstown from obtaining such a policy from the conventional market.
1950's	• Fred Reiss formed an insurance subsidiary for a US mining client when he was unable to find an insurance company to cover his client's multiple risks. He coined the name "captive" from his mining client who referred to its mines as "captive mines". • Licensing captives was prohibitively expensive. Regulators in the US, UK and many European countries did not acknowledge the controlled risks of a captive would result in less exposure to loss. They required captives to have the same level of capital as traditional insurance companies.
1960's	• Reiss began to search for other jurisdictions that would understand the nature of captives. • In 1962 Reiss convinced the Government of Bermuda to pass a special Act of Parliament to allow the formation and management of captives from the Island for international clients.
1970's	• Major reinsurance companies and the direct insurance market began to realize clients that retained a portion of their own risk were likely to manage these risks more effectively. • The European reinsurance market (Swiss Re, Mercantile & General Re and Lloyds of London), together with General Re of America, drove the development of reinsurance pools. Criteria used by the underwriting committees encouraged the use of risk engineering programs to establish credible probable loss estimates and to encourage risk improvement. • Hundreds of captives were formed in response to the return of restrictive underwriting in lines such as product liability and medical malpractice. This caused workers' compensation and liability rates to skyrocket. • Realizing they were missing out on a lucrative source of business, various state legislatures started passing laws granting captive insurance companies the same benefits they could derive offshore.
1980's	• By 1980 the number of captives worldwide increased to 1,000. • Domicile locations increased with the growth of the captive industry.
1990's	• A soft market during the 1990's slowed the growth of captives.
2000's	• Insurers tightened underwriting practices. • After the September 11, 2001 attacks, one-third of property and casualty carriers lost significant value.
2010's	• Interest in captives is at an all-time high. • As of 2013, the industry has about 6,500 captive insurance companies around the world. • As of 2013, the industry has nearly 60 domiciles around the globe. • Focus on increased tax transparency is driving more collaboration among governments.

Captive Insurance Offers a Viable Economic Solution to Commercial Insurance Market Challenges

The principal rationale for creating captive insurance companies arose from the greater level of physical risk control exercised by parent companies, which subsequently reduced their physical risk. This permitted an insurance program to be priced lower than the insurance market could offer and allowed greater flexibility in policy covers and wordings. Unfortunately, potential captive owners frequently found that insurance legislation in their own country did not provide the flexibility they desired. It was the reduced bureaucracy, not the potential tax advantages that attracted US and foreign companies to domicile their captives in other countries.

Risk Management Remains Primary Benefit of Captives

In 1977 the US Internal Revenue Service issued ruling 77-316. The ruling specifically denied the deductibility of insurance premiums paid by a parent company to its wholly owned insurance subsidiary if it only insured the risks of the parent because these risks were not transferred out of the economic family.

The ruling led to changes in the industry including a move to form group captives rather than wholly-owned captives, and expanding the role of existing captives to include underwriting unrelated party risks, thus turning captives into bona-fide commercial insurance companies. Even with these changes, many parent companies continued to form wholly owned captives because the efficiencies obtained through focused risk management and the access to specialty insurance coverage and reinsurance markets outweighed the tax considerations.

Captives and Lines of Coverage Continue to Grow

In terms of numbers, Vermont remains the largest US domicile licensing their 1000th captive in 2013 and Bermuda the largest domicile outside the US with over 800 captives according to Business Insurance "Captive Managers and Domiciles".

Lines of coverage are extending beyond traditional products to include product liability, workers' compensation, professional liability (medical malpractice) and non-traditional areas such as employee benefits. Growth in funding employee benefits through a captive would mean more business in the US because benefits regulated by the Department of Labor's Employee Retirement Income Security Act are required to be domiciled onshore.

Summary —While the OECD is trying to achieve tax harmonization, its member countries are striving to attract international business to their shores. It is likely members will continue to adopt policies to support their own economic advantage making it difficult to achieve consensus. This lack of agreement will not deter OECD's pursuit of preferential tax regimes. When creating and managing a captive it is important to clearly establish that the reasons the captive was formed in its chosen domicile are not based on tax minimization opportunities.

III. Meeting the OECD Action Plan Requirements for Coherence

In Action 4 the OECD targets "excessive" interest and other financial payments. Premiums paid to captive insurance companies fall into this "catch all' category. To counter this claim it is essential to be able to show that premiums have been determined in accordance with accepted practices within the insurance marketplace. In cases where premiums are paid for difficult or impossible risks to insure, it is essential to provide detailed financial analysis of the method by which the premium was determined.

Risk Mitigation is Complex Issue for MNEs

As multinational enterprises (MNEs) grow in revenues and international reach, their need to mitigate risk increases and becomes more complex. Many MNEs create captives to:

- Manage unique business risks
- Centralize global risks into one entity
- Efficiently perform the administrative aspects of insurance and associated risks

Related Party Transactions

Because captives are established by MNEs, the premiums being paid to the captive are considered related-party transactions as defined by both the United States (US) Treasury regulations and the Organization for Economic Cooperation and Development (OECD) Guidelines for MNEs. The premiums, as regulated by transfer pricing principles, are to be consistent with what third-party insurance providers charge their customers. Pricing between third-party enterprises is defined as arm's-length under transfer pricing principles, which helps to regulate premiums paid to captives.

Third-party transactions involving captives relate to the premiums paid by the insured to a non-related captive insurer. Captive insurance companies may be owned by a single entity (including the insured owning the captive), a number of companies from a specific industry, or a number of unrelated companies from different industries.

Arm's Length Principle

Simply stated, the arm's-length principle requires that compensation for any intercompany transaction conform to the level that would have applied had the transaction taken place between unrelated parties, all other factors remaining the same. It is the core concept of matching profitability with the provision of tangibles, intangibles and services. In the case of captives, the arm's-length principle helps to ensure that the captive receives a sufficient premium for its insurance coverage and that the insured is not over or under paying for the insurance coverage.

In the US, the arm's-length standard is defined in Section 482 of the Regulations of the Tax Code and requires related-party transactions, including insurance premiums, to be at tax parity with third-party transactions. The Section 482 Regulations further provide that the arm's-length standard be applied to all intercompany transactions and that the arm's-length standard is met "if the results of the [intercompany] transaction are consistent with the results that would have been realized if uncontrolled taxpayers had engaged in the same transaction under the same circumstances …."

In addition to Section 482 the Internal Revenue Service is empowered by Section 845(a) to allocate between related parties to a reinsurance contract the associated income, deductions, asset reserves, credits and other

items, to re-characterize such items; or to make any other adjustments in order to properly reflect the source and character of those items.

Although these two sections overlap, nothing in either section precludes the IRS from choosing one over the other or from relying on both at the same time, as it once did when challenging a reinsurance arrangement involving an offshore captive that was affiliated with the taxpayer (Wright v The Commissioner).

OECD member countries have agreed that the arm's-length principle, as outlined in the OECD Guidelines, should be the international standard for determining transfer prices among related parties. The OECD Guidelines further stipulate that conditions made or imposed between related parties should not differ from those that would be made between third parties engaging in similar transactions under similar circumstances.

Valuation of Transfer Prices

Although the principle can be simply stated, the actual determination of arm's-length compensation is notoriously difficult. Important factors influencing the determination of arm's-length compensation include the type of transaction under review as well as the economic circumstances surrounding the transaction.

The arm's-length nature of intercompany transactions is determined using various methodologies as prescribed by the local country's transfer pricing regulations and/or the OECD Guidelines. Often local tax authorities provide additional guidance as to acceptable methods of analyzing related party transactions. Case law also helps to provide guidance on how the transfer pricing methodologies should be properly applied.

In the US, the Section 482 Regulations provide different methodologies for testing intercompany transactions based on the type of transaction being evaluated. Insurance premiums paid to captives fall under the methodologies available for services. The Section 482 Regulations have six specified methods to analyze the arm's-length nature of the intercompany service transactions.

1. **Services cost method —** allows for certain specified services to be charged at cost
2. **Comparable uncontrolled service price method —** uses the actual price charged as compared to third parties
3. **Gross services margin method —** uses a comparison of the gross margin of the transaction compared to third-party transactions
4. **Cost of services plus method —** uses the comparison of a gross services profit markup as compared to independent companies
5. **Profit split method —** allocates profit based on the value of contribution made by each of the parties involved in the transaction
6. **Comparable profits method —** uses various financial ratios, such as the operating margin or the total services costs plus ratio, of the least complex entity in the transaction as a comparison to independent companies

Similarly, the OECD Guidelines provide methodologies to analyze the arm's-length nature of intercompany transactions. The OECD Guidelines have five specified methods to analyze the arm's-length nature of the intercompany service transactions.

1. **Comparable uncontrolled price method (CUPS) —** uses the actual price charged as compared to third parties

2. **Resale price method —** uses a comparison of the gross margin of the transaction compared to third-party transactions
3. **Cost plus method —** uses the comparison of the markup incurred as a comparison to independent companies
4. **Profit split method —** allocates profit based on the intangibles owned and contributed by each party to the intercompany transaction
5. **Transactional net margin method —** similar to the comparable profits method, uses various financial ratios of the least complex entity in the transaction as a comparison to independent companies

The Section 482 Regulations, OECD Guidelines and other local transfer pricing regulations require that the method used to analyze the intercompany transaction be based on the specific facts and circumstances of the related party transaction and the available comparable data. Based on these criteria, one of the methodologies must be applied to confirm the arm's-length nature of the intercompany transaction. In the case of captives, the methodology will also identify whether the pricing is appropriate based upon the capital of the captive and the amount of risk it is retaining.

It is important to understand the underlying aim in seeking comparative information is to support the validity of a transaction. If it can be shown that independent third parties have agreed to terms similar to those set between the insured and the captive, it substantiates the transaction. A comparable search may be undertaken to identify CUPs, gross profit margins for use in applying the resale price method, cost markups for use in applying the cost-plus method, or other information required to apply or support other pricing methods.

Comparative information may be sought from a variety of sources and will broadly fall into two categories:

- Identified internally within the group
- Available from external sources, which reflect transactions not carried out by group companies

It is advisable to perform a thorough analysis of past group transactions with third party insurers to ascertain whether any comparable transactions exist. Internal support for the transaction may be preferable to a similar external transaction for a number of reasons, including:

- They are more likely to "fit" the affiliated transaction as they occur within the context of the group's business
- More information about the internal comparable situation is more likely to exist and be readily available
- One internal comparable may be sufficient to support the transaction if it comes under regulatory review, whereas a wide base of support may be required if external examples are used

Obtaining detailed information regarding transactions carried out by independent entities may not be easy to find, and the extent to which useful information is available varies from country to country. Sources of information regarding third-party comparable transactions include:

- Government (e.g. statutory public filing requirements and government trade department publications)
- Commercial databases
- Industry associations
- Employee knowledge

Of the many sources of information for conducting a search for comparable transactions, the most important source may be the people within the captive insurance industry. Trade associations publish trade journals,

conduct market studies and/or employ experienced industry experts who may provide a wealth of valuable information. Estimates of arm's-length premium obtained by seeking quotes from independent brokers have been rejected by regulators as not being a reliable measure of arm's-length price.

Test of Reasonableness

Seeking comparable transactions is not an exact science. The information collected is rarely precisely the same as the transaction a company is undertaking and it may be necessary to document the reasonableness of the comparison before determining appropriate transfer prices. The test of reasonableness should be based on a financial analysis of the projected results of applying the comparative information.

Company or Industry-Specific Risks

Certain risks insured by captives are industry or company specific, thus insurance coverage may not be available in the commercial marketplace. It is essential that the exposure to the company be clearly documented and supported with financial analysis of the possible maximum loss to which the company can be exposed to ensure acceptable premium pricing.

Summary —Transfer pricing regulations in the US and among OECD member countries require captive owners to demonstrate their insurance premiums were determined in line with the arm's-length standard, and their transactions are consistent with third-party activities within the captive insurance industry.

IV. Meeting the Action Plan Requirements for Substance (Value Creation)

In Action Plans 8, 9 and 10 the OECD is seeking to align profits with value creation. They are hoping to achieve this by:

- *Ensuring profits made by various group companies are in line with the economic and intellectual substance of the activities undertaken by the group company making the profit and by focusing on where important people functions are performed*
- *Ensuring that capital allocated, and in the case of captives, the premium paid to any group company is in line with the risk it has contractually assumed, and if not, re-characterizing the transaction*
- *Preventing abusive transactions that would not, or would only very rarely, occur between related parties*

Transaction Rather than Form Determines Tax Consequences

Over the years the United States (US) and other countries' tax courts have applied various common law principles to evaluate tax positions of multinational enterprises (MNEs) such as "substance over form", "business purpose of the transaction" and "economic substance". The Organization for Economic Cooperation and Development (OECD) first raised the issue of substance over form in its 1995 Transfer Pricing Guidelines. The substance over form analyses have been used to dissect self-serving transactions between parties, including transactions between:

- Related corporations and their shareholders
- Partnerships and their partners
- Trusts and their beneficiaries

The standard applied uses the substance of the transaction, rather than its form, to determine the tax consequences, with few exceptions. That is, the form of a transaction is only a label the interested parties attach to transactions. Tax authorities are not concerned with such labels or documents that purport to govern transactions, but rather they focus on the substance of such transactions. Related-party transactions provide fertile territory for self-dealing, with the tax benefits as the real motivating purpose, disguised by the form of the transaction. In contrast, arms-length transactions with independent third-parties, both internal and external to MNEs, are far less vulnerable.

Overview of Economic Substance

Economic substance is a common law doctrine that denies tax benefits for transactions that lack economic purpose. The doctrine is used to invalidate transactions that may be in compliance with the statutory provisions of a country's tax code, but have been entered into for the sole purpose of avoiding taxes. The economic substance doctrine has in the past generally been determined in the form of a two-tiered test requiring the:

- Transaction under consideration impact the taxpayer's economic position
- Taxpayer have a legitimate non-tax business purpose for entering into the transaction

The first tier relates to an objective standard that can be measured, while the second is more subjective and is tied to the MNE's intentions. However, the OECD Transfer Pricing Guidelines and more recently its Base Erosion and Profit Shifting (BEPS) report have introduced a third criterion, that of management and control of the transaction, in particular where they are located. The OECD defines control as "The capacity to make decisions to take on the risk and decisions on whether and how to manage the risk internally or using an external provider". This is similar to the "mind and management" doctrine used by the US Internal Revenue Service (IRS) to determine from where the transaction is controlled.

In the past it was generally believed that MNEs had the right to arrange their business transactions so as to minimize their tax liability. However, the economic substance doctrine denies an MNE beneficial tax treatment for transactions entered into for the sole purpose of avoiding taxes. A taxpayer must show both an objective change in the taxpayer's economic position and a subjective non-tax purpose for entering into the transaction. The objective aspect of the test should be satisfied so long as the transaction changes the MNE's financial position. The subjective aspects of the test now depend on showing the decision of the MNE to enter into the transaction was not tax driven, but also that management of the transaction is at arm's-length.

Economic Substance Doctrine

Historically, the economic substance doctrine has been applied to transactions of MNEs involved in perceived tax avoidance schemes. Tax courts have combined separate transactions where there is an overall scheme to generate tax benefits. Similarly, where a tax-motivated transaction is coupled with unrelated substantive transactions, courts may isolate the tax-motivated transaction. Therefore, when entering into a series of transactions, MNEs evaluate whether the series as a whole has economic substance and whether each transaction, separately, has economic substance.

Risk Management has Become a Corporate Strategy

The role of risk management in MNEs has grown significantly over the past 30 years. Previously the job of the corporate risk manager, typically a low-level position in the corporate treasury or human resources department, was mainly involved in the purchase of insurance and establishing safety standards in the work place. Today risk management is an integral part of a MNE's overall corporate strategy and includes oversight of a variety of risks, such as operational, reputational and most recently, strategic risk. The risk management departments have evolved from cost centers into corporate profit centers through the use of alternative risk solutions including the formation of captive insurance companies. Today, the risk management functions of MNEs are directed by senior executives with titles similar to chief risk officer and directly overseen by boards of directors or CEOs.

A MNE can manage its risks in one of two fundamentally different ways:

- One risk at a time, on a largely compartmentalized and decentralized basis
- All risks viewed together within a coordinated and strategic framework

The latter approach is often called "enterprise risk management" (ERM). ERM is a strategic business discipline that supports the achievement of an organization's objectives by addressing the full spectrum of its risks and managing the combined impact of those risks as an interrelated risk portfolio. ERM provides a framework for risk management, which typically involves identifying particular events or circumstances relevant to the organization's objectives (risks and opportunities), assessing them in terms of likelihood and magnitude of impact, determining a response strategy and monitoring progress.

ERM Provides a Competitive Advantage

By identifying and proactively addressing risks and opportunities, business enterprises protect and create value for their stakeholders, including owners, employees, customers, regulators and society overall. Regulators and debt rating agencies have increased their scrutiny of the risk management processes of companies, particularly, how these functions are valued and how the income is allocated across the activities.

According to the Risk and Insurance Management Society, ERM represents a significant evolution beyond previous approaches to risk management in that it:

- Encompasses all areas of organizational exposure to risk (financial, operational, reporting, compliance, governance, strategic, reputational, etc.)
- Prioritizes and manages those exposures as an interrelated risk portfolio rather than as individual “silos”
- Evaluates the risk portfolio in the context of all significant internal and external environments, systems, circumstances and stakeholders
- Recognizes that individual risks across the organization are interrelated and can create a combined exposure that differs from the sum of the individual risks
- Provides a structured process for the management of all risks, whether those risks are primarily quantitative or qualitative in nature
- Views the effective management of risk as a competitive advantage
- Seeks to embed risk management as a component in all critical decisions throughout the organization

Captives Play an Integral Role in ERM

From an overall perspective, ERM creates value and substance by enabling senior management to quantify and manage the risk-return tradeoff facing the entire MNE. By adopting this perspective, ERM helps the MNE maintain access to the capital markets and other resources necessary to implement its strategy and business plan. In the world of MNEs, where financial troubles and supply chain problems can disrupt a corporation’s operations, a bad outcome resulting from an insurable risk can have implications that can go well beyond the immediate hit to cash flow and earnings. For most MNEs, guarding against such a scenario is vital to its very existence and many utilize a captive to provide ERM insurance coverage thus supporting the main function of corporate risk management by protecting a MNE’s ability to carry on its business plan no matter what adversity transpires.

The development of or participation in some form of alternative risk transfer vehicle such as a captive has become an accepted technique in which MNE’s can address the issues of availability and affordability of protection, while eliminating the necessity of “trading dollars” with commercial insurance enterprises. The use of captive insurance companies within ERM has been an extremely efficient and effective strategy for addressing the risk management needs within a MNE.

Risk Distribution is an Accepted, Necessary Business Practice

Shifting risk by means of an insurance contract is an accepted prudent business practice. Shifting risk to an affiliated captive is an equally bona fide transaction as the captive must meet regulatory, actuarial, accounting and capital requirements in the domicile of its incorporation to be able to assume risk. Premiums are determined by accepted arm’s length pricing mechanisms supported by actuarial studies or other financial analysis. Insurance programs utilizing captives involve real economic transfer of risk and result in the payment of losses that could have otherwise been absorbed by the commercial marketplace. This is undertaken pursuant to legally binding insurance contracts between two separately incorporated entities. Most countries’ tax authorities already require that internal transactions be priced at arm’s-length, have economic substance and do not involve tax avoidance.

MNEs in the course of their normal activities may take many strategic or business risks that they cannot profitably/reasonably lay off in capital or other developed risk transfer markets. If a MNE were to seek a third-party to bear such business risks, the costs of transferring the risks would likely be prohibitive, because they would have to be high enough to compensate the third-party for accepting the transaction. Therefore MNEs assume this risk through their own captives for business and economic reasons.

Captives today are frequently managed by risk managers who have advanced degrees such as MBAs in finance and have attained professional designations from organizations such as the American Institute of Chartered Property Casualty Underwriters (CPCU). To function effectively and be financially successful, captives are managed by personnel requiring advanced knowledge and training. Qualifications include professional designations, such as Certified Public Accountant (CPA), Certified Risk Managers (CRM) sponsored by the National Alliance for Insurance Education & Research and CPCU and Associate in Risk Management sponsored by the American Institute for CPCU. Captives managed on behalf of other countries' MNEs require equivalent qualifications. The advanced knowledge and training of these senior managers complies with the OECD requirement that MNEs must be able to demonstrate the economic substance of the transaction and have people with the knowledge, authority and ability to control the company and the risks it accepts.

The size of this type of risk to MNEs is substantial. The captive has to have the capital base necessary to withstand significant losses and must price the risk at arm's-length to ensure it receives enough premium for the exposure underwritten. Premiums and capital must be within the regulatory guidelines of the captive domicile, which will assist in establishing the economic substance of the captive.

Summary — The OECD's BEPS Report and Action Plans infer that captives are used to artificially transfer income from MNEs in a taxable jurisdiction. In reality, the formation of captives is driven by corporate risk management strategies that have substantial business purpose and are managed by key personnel who understand all aspects of each MNE's risks.

In light of the OECD's demand for senior and experienced decision makers within the captive itself, it is likely the value added in the captive domicile compared to the value added by personnel located onshore, for example in the head office, may be evaluated. Where it appears non-tax benefits to the group from the transfer of risk are limited, or where the captive is too heavily dependent on personnel elsewhere in the group for underwriting, policy documentation and pricing, challenges can be expected.

V. Meeting the Action Plan Requirements for Transparency

In Action Plans 5, 12 and 13 the OECD is attempting to counter harmful tax practices by requiring taxpayers to disclose their "aggressive tax planning arrangements", by improving transparency with entities domiciled in "preferential tax regimes" and by requiring improved transfer pricing documentation providing greater information on MNEs allocation of income, economic activity and taxes paid among the countries in which they operate.

Demand for Tax Transparency Increasing

The demand for tax transparency has grown at an accelerated rate over the past decade as the push for fairness and equality of the global tax burden has been highlighted in the public's eye. Events such as the 2008 downturn as well as the financial and banking crises that preceded it have fueled the transparency fire. This has resulted in Dodd Frank, the Foreign Accountant Tax Compliance Act, European Union directives, Organization for Economic Cooperation and Development (OECD)-compliant double tax treaties and other global initiatives. These initiatives are designed in whole or part to achieve clear and accurate reporting of corporate accounting and tax transactions.

These concepts have been developing over time as investors and the public grow better informed about such matters. The push for tax transparency has developed utilizing both voluntary and mandatory measures. Current requirements and regulations exist to provide the inherent controls needed to prevent harmful tax practices and provide transparency within the regulatory, financial reporting and tax compliance domains.

At stake is investor and consumer confidence, the reputation of corporate management and belief in the overall system of taxation, including captives.

Regulatory Controls

Mandatory information submitted to regulators includes much of the arm's-length documentation that is required from many transfer pricing guidelines. Inherent controls are present through the due diligence that is the process of forming and applying for regulatory approval as a captive. Domiciles in the United States (US) and offshore require much of the same information in their application process, and include but are not limited to:

- Biographical information of directors and officers (provides background of individuals responsible for the business)
- Feasibility study (sets out purpose and direction of captive program)
- Comprehensive plan of insurance coverage including risks to be insured, fronting company, expected premium, retained risk, reinsurance program, risk management program, history of loss experience, organization chart and identification of parent (if applicable) and financial projections under differing scenarios (validates the desired insurance program)
- Description of management structure and geographical location of operations provided in regulatory filings, including organizational documents (provides insight into management program and logistics of operation)
- Approval of professional service level organizations for audit and tax, actuarial, captive management, etc. (provides assurance of competency of captive management, attest, and actuarial functions)

The application process is designed to vet the purpose, structure and intention of the captive as well as the individuals managing the program and the ultimate owners.

The regulatory scrutiny of the ongoing operative of the captive is as important as the application and approval process. This is examination is achieved through domiciliary captive regulation that monitors and subjects most transactions to its approval process. The following is a representative listing of transaction/action types that would require approval in most domiciles:

- Policyholder dividends
- Non-repetitive equity transactions
- Loan backs
- Change in insurance program
- Reinsurance
- Change in professional service providers
- Business plans and forecasts
- Mergers/acquisitions/dissolutions
- Permitted practices/waivers
- Letters of credit
- Investment holdings/programs

The approval requirement of such identified transactions is designed to protect policyholders and other interested parties from fraud, bad acts, inefficient management of service providers and potential adverse tax positions or transactions.

All captives are institutionally required to file their regulatory financial statements, coupled with any other annual filing requirements that may be due (actuary report, premium tax report, etc.). These reports serve as documentation and information that can be utilized to assess tax positions that may be injurious to the captive as a whole.

The application process, transaction approval and ongoing regulatory filings represent a considerable amount of documentation. This serves to substantiate that a captive program's operation and underlying financial data is sound and can be relied upon for tax filings.

Financial Reporting Control

The European Union has established optional documentation guidelines for MNEs that participate in cross-border intra-group transactions in Europe. In addition, the Pacific Association of Tax Administrators has provided optional guidelines for transactions in Australia, Canada, Japan and the United States (US). Many of the documentation requirements in these guidelines are inherently provided by captive insurance companies as part of their certified audited financial statements. Many established domiciles require certified audited financials for captive insurers.

In reviewing the operations of a MNE, group taxing authorities want to understand the economic reality of the business. The audited financials of a captive provide a wealth of information on this topic including, but not limited to, the following:

- General description of the captive including ownership, related party insureds and the types of risk underwritten
- Premiums written and premiums earned, including any reinsurance activity
- A roll forward of loss reserves including loss reserves incurred and paid

- Investment detail including the break out of investments by type and fair value valuation
- Summary of significant accounting policies that explains the valuation of assets and liabilities in accordance with Generally Accepted Accounting Principles or International Financial Reporting Standards
- Details of shareholders' equity including information on common stock, contributed surplus, dividends, unrealized gains/losses and other items that impact shareholders' equity
- Multiyear comparative disclosures of federal, foreign and local tax position
- Descriptive disclosure of any significant transactions including, but not limited to, restructurings
- Disclosure of intangibles and valuation considerations
- Particulars on intercompany loans including parties involved and the principal amounts involved in the arrangements
- Information on significant related party transactions

Audited financial statements clearly help give a picture of the drivers of business profits.

For most captive insurance companies, the largest driver of business profits is associated with related-party premiums. The valuation of these premiums is subject to review as part of the financial statement audit. A large part of this review may be encompassed in the actuarial report and opinion on loss and loss expense reserves, that is often required as part of the financial statement audit. This report and opinion outline the assumptions, inputs and methodologies used in models used to estimate losses and loss expenses which normally represent the largest component of premiums.

As it relates to reinsurance contracts, qualified professionals review benchmarks and the terms and conditions of reinsurance contracts against the following:

- Similar contacts in the market
- Local and regional comparables

These inputs are then evaluated in testing and documenting the best method used for reinsurance pricing.

Tax disclosures give clarity to a captive's overall tax position. The following drivers of the tax position are revealed:

- Federal, foreign and local jurisdictions where the captive insurance company is subject to taxation
- Tax rates related to the various jurisdictional filings
- Overall effective tax rate paid when considering all tax jurisdictions
- Significant drivers of the effective tax effect
- Items that will create future tax deductions or tax liabilities
- Entities included in any consolidated tax filings
- Methodology of payment of taxes or tax allocation method used within a consolidated group
- Earnings of a foreign subsidiary that have not yet been distributed and not yet recognized in federal taxable income

Under International Accounting Standard 12 and Financial Accounting Standards Board Interpretation Number 48, if a tax position taken is uncertain in relation to its ultimate sustainability, the benefit of this tax position may not be taken on the audited financial statements. A common uncertain tax position relates to transfer pricing or arm's-length pricing of a related party transaction. Often, the uncertainty does not relate to the aggressiveness

of the taxpayer. It relates to the difficulty of a MNE to satisfy divergent transfer pricing requirements of various local country regimes while also satisfying guidance given by international organizations such as the OECD. Frequently, an uncertainty is related to how a taxing regime would conclude on the economics of a transaction rather than an effort to avoid taxation. An uncertain tax position such as transfer pricing is required to be disclosed in the audited financial statements thereby giving transparency to whether the issue exists.

The audited financial statements and the documentation that support audit test work provide a good basis for providing clarity to captive transactions. Given the differing contemporaneous documentation requirements obligated by the taxing authorities throughout the world, the financial statement audit and supporting documentation cannot satisfy these requirements, but can give a good base. Formalizing and augmenting some of this documentation so that it covers more completely OECD's guidelines and local country guidelines where significant economic activity occurs will help clear up misunderstandings related to a captive's operations.

Tax Return Compliance Reporting and Related Controls

Captives and other business enterprises are mandated by numerous sources to maintain proper documentation of their financial accounting, tax, actuarial, legal, banking, investing and other documents as part of their normal business operations and internal controls. These documents should provide a significant level of comfort when assessing whether income and profits are properly allocated to appropriate jurisdictions within the organizational structure.

Presented below is a listing of tax compliance related documents that serve within themselves to support proper jurisdictional filings, income allocation and appropriate tax compliance filings.

Transfer Pricing Documentation

Estimates indicate more than half of the world's trade occurs within MNEs. Taxing jurisdictions and business enterprises are increasingly focused on transfer pricing. Transfer pricing is a profit allocation method used to apply a MNE's net profit (or loss) to their properly attributed jurisdictions. Transfer pricing involves the terms and prices at which related parties sell (or should sell) goods or services to each other. When the members are based in different taxing jurisdictions, there is an opportunity to reallocate income to lower-taxing jurisdictions.

To reduce losses of income tax revenue, more than 40 countries have adopted transfer pricing rules and requirements. While unrealistic transfer prices do not affect the overall enterprise directly, they become a concern when they are misapplied to reduce profits of an entity whose tax jurisdiction has high taxes and increase profits in a country that that has little or no tax rate.

Transfer pricing documentation is crucial in order to prove to the tax authorities that a transfer pricing policy is arm's length. In other words, if a MNE can show what its policy was, how it interpreted that policy and why the prices chosen satisfy the arm's-length standard, then the tax authority has little choice but to accept the policy. MNEs that have not properly documented their policies are likely to face severe problems in the context of an intensive transfer pricing audit.

Typically transfer pricing documentation is in a format that is recognized and accepted by tax authorities. The regulations of many countries require taxpayers to document that amounts charged are within the transfer pricing guidelines. Substantial penalties exist in some taxing jurisdictions for the misstating of pricing on regulatory filings (tax returns).

The transfer pricing process may include, but not be limited to, industry analysis and risk assessment, composition of master and local files, company analysis, functional analysis, economic analysis (method selection and benchmarking) and financial analysis and contemporaneous documentation.

Documentation of a transfer pricing study should include, but not be limited to, (represents mix of US and European model) the following:

1. Industry overview including analysis of economic and legal factors affecting pricing
2. Company's organizational structure covering all related parties
3. Strategy
4. Functional analysis
5. Description of goods and services
6. Description of comparable uncontrolled transactions/how comparability evaluated
7. Forecasts and projections relied upon in selecting method
8. Transfer pricing method selection including explanation of selection and alternatives
9. Benchmarking study of comparable companies/transactions

In consideration of the level of detail and technical analysis as well as the underlying documentation that is required in producing and validating a transfer pricing study, taxing authorities routinely rely on these documents to satisfy themselves as to the accuracy of the income and ultimate tax allocation of the entity to its proper jurisdiction(s).

Regulatory Documents and Tax Compliance Filings

Documentation that is required as part of regulatory and tax compliance filings are also part of the standard documentation requests required at the onset of any taxing authority audit. These documents can serve as testimony to the accuracy of an entity's income allocation and tax filing compliance. Below is a non-comprehensive listing of such filings.

1. Annual reports/audited financial statements (includes pertinent disclosures and relevant financial tax information)
2. Feasibility studies (describes purpose and nature of captive operation)
3. Trial balances (provides detail information about accounts of the company)
4. Claims history (provides relevant information regarding performance of insurance program)
5. Actuarial opinions (includes information on insurance liabilities, development, claim status)
6. Insurance policies (provides relevant source document)
7. Transfer pricing studies or advanced pricing agreements (provides base documents substantiating pricing method and policy)
8. Financial Accounting Standards Board Interpretation 48 (FIN 48)/Statements of Statutory Accounting Principles (SSAP SR)/International Accounting Standard (IAS) 12 (disclosures information on uncertain tax positions)
9. Internal Revenue Service (IRS) Form(s) 5472 and 5471 (discloses nature/amount of certain dealings with non-US entities)
10. Protective filings (gives insight into presence in foreign jurisdiction)
11. Foreign Account Tax Compliance Act (FATCA)/Report of Foreign Bank and Financial Accounts (FBAR) filings (discloses foreign financial account information)
12. (IRS) Form 8886 (discloses reportable/listed possible tax avoidance transactions)

The information that is disclosed within these documents is detailed, informative and substantial. All are aimed at tax transparency and accurate reporting. Captives are subject to these fillings, if required.

Summary —The information captives are required to disclose in regulatory filings upon formation and during their operation combined with their financial and tax compliance reporting is substantial. Significant and consistent documentation standards and practices could assist the tax administrator to more efficiently assess tax compliance and perhaps alleviate some of the potential misunderstanding of the captive's operations. Lastly, compliance with OECD's Action Plan on documentation will help alleviate misunderstandings related to the captive industry.

VI. Meeting the OECD Action Plan Requirements for Tax Practices

As mentioned in Chapter 5 the OECD is attempting to counter harmful tax practices by introducing Action Plans 5, 12 and 13. In Action Plan 3 it is the OECD's aim to strengthen member countries' Controlled Foreign Corporation (CFC) rules. It is therefore essential that captives not only work within their own countries' tax laws but the tax laws of countries in which their risks might be located.

Tax Treatment of Captives Formed by MNEs that are US Taxpayers

As previously discussed, the primary purpose for forming a captive or choosing a domicile location should never be tax motivated. It would be unreasonable to suggest that an entity ignore the tax effect, but this should be secondary to other significant non-tax advantages identified during the feasibility analysis. A company should have clear and formal documentation of all benefits for the formation of its captive.

Basics for Insurance Company Tax Treatment

The business activities and products of an insurance company are fundamentally different from other entities. This has produced unique tax efficiencies that may not be afforded to other non-insurance entities. However, in order to realize these efficiencies, a captive must meet the necessary insurance company criteria to be treated as an insurance company for federal tax purposes. Based on the nature of a captive's operations, this can be challenging, and is subject to many of the topics previously discussed in this paper.

Internal Revenue Code (IRC) sections 816(a) and 831(c) and Treasury Regulation section 1.801-3(a)(1) define an insurance company as a company whose primary and predominant business activity (more than half) during the tax year is the issuing of insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies. This represents the extent of the direct definition of an insurance company within the United States (US) tax code. As such, insurance for tax purposes is largely defined by judicial precedent and subsequent IRS guidance, which currently involves the following three-pronged framework established by the tax courts:

1. **Presence of insurance risk is required**
   Insurance risk is generally the result of an unanticipated event, such as a fire or accident that causes an economic loss. This risk must represent more than 50 percent of an entity's revenue and cannot be a business or investment risk.

2. **Risk shifting and risk distribution is required**
   An insurance contract must transfer/shift some or all of the risk of economic loss from the policyholder to the insurance company *and* the risk should be distributed widely enough among unrelated parties so that the statistical phenomenon known as the law of large numbers can work. Certain brother-sister related parties that are separate legal tax entities may be viewed as unrelated based on guidance issued by the IRS and tax courts. A captive can fail risk shifting if it has insufficient capital, excessive guarantees or loan backs to its parent, or is indemnified by another entity.

3. **Commonly accepted notions of insurance should exist**
   This is largely based on the specific facts and circumstances of an entity and should consider the following:
   - Organizational structure
   - Substance of the transactions
   - Nature of the operations

- Regulatory status in the domicile
- Adequacy of capital for the risk assumed
- Existence of valid binding contracts with premium established at arm's-length

It's important to note that a captive can be treated and regulated as a bona-fide insurance company for regulatory purposes, but still fail to meet the federal tax criteria. In addition, the framework should be viewed as general guidance because a captive's insurance position is based predominately on the specific facts and circumstances relevant to that particular entity. Insurance positions for captives continue to be subject to controversy and litigation due to the related party nature of their transactions and the unique risks they insure. It is important for captives to routinely assess their operations and organizational tax structure in order to document their compliance with evolving guidance.

US Tax Efficiencies for Insurance Companies

Subchapter L of the IRC is the authoritative base for US insurance company taxation. The most significant tax advantage for an insurance company relates to the allowable deduction for a discounted estimate of loss and loss expense reserves, a portion of which will likely remain unpaid for many years. This is significant because it allows a captive to accelerate deductions that would ordinarily be spread over a longer period of time, paying tax up-front on the projected profit portion of an insurance contract. This is unlike a traditional company that would be subject to tax in the year cash is received and only allowed a deduction for actual costs incurred to sell those goods during the tax year. Only insurance companies are allowed a deduction for an estimate that does not meet the all events test and economic performance rules of IRC section 461.

When a captive qualifies for insurance tax treatment, the policyholder is allowed a deduction for the full premium paid to the captive. The captive is allowed to offset this income by accelerating its loss deductions as noted above. This can provide a significant tax advantage when the captive is part of larger group of affiliated entities because the captive can employ the tax deferred capital for other investment opportunities and retain the benefits within the controlled group.

A captive that qualifies for insurance treatment and has less than $1.2 million in net annual premiums written may elect to be taxed as a small insurance company under IRC section 831(b). This election provides a significant tax advantage because the captive only pays tax on its investment income, less certain allowable expenses. The underwriting profits and losses experienced by the captive are not taxed. The advantage to the parent is even more significant because it gets to deduct the full premium paid to the captive. Later, the parent can potentially remove the previously untaxed profits of the captive at favorable tax rates.

Another potential tax efficiency for captives relates to state income taxes. Unless the captive creates nexus in a particular state, it is typically exempt in most cases from paying state income taxes. However, the captive is typically subject to premium taxes in any state in which risk is underwritten and can also be subject to procurement taxes in certain states.

Foreign Considerations for Captives

A foreign captive that is more than 25 percent owned by US shareholders is subject to the CFC rules of IRC sections 951-965, often referred to as subpart F. A US shareholder is defined as a US person, as defined in IRC section 957(c), who owns directly, indirectly, or constructively 10 percent or more of the total combined voting power of all classes of stock entitled to vote in a foreign corporation. These rules are used as a means to prevent erosion of the domestic tax base and to discourage residents from shifting income to jurisdictions that do not impose tax or that impose tax at low rates. Subpart F limits the deferral of certain types of income earned

by a CFC by generally requiring the US shareholder to include their pro rata share of the CFC income in their return. In addition to the substantial tax rules, the reporting and record keeping required is extensive and is enforced with substantial penalties for noncompliance. These already complex rules will be strengthened by Action 3 of the OECD Action Plan.
A CFC that qualifies for insurance treatment may elect to be treated as a domestic corporation for US tax purposes under IRC section 953(d). Due to the extensive rules under subpart F, many CFC insurance companies decide to make this election. A captive that elects this treatment is treated in nearly all aspects as a U.S. taxpayer, which also means the federal excise tax (FET) does not apply.

A foreign captive that is not a CFC would be subject to FET under IRC section 4371 for any US risk insured, unless the captive is eligible for a treaty exemption. The tax is typically imposed on the last domestic entity shifting the risk offshore, but either party can be held liable to the US for the tax.

How Captives can be Accused of Tax Abuses

Recently, formation of captives for businesses in the middle market space (i.e., businesses under $1 billion in revenue) has increased significantly. Because of the size of captives, many qualify for a small insurance company tax election under IRC 831(b), which is limited to insurance companies with $1.2 million in annual premium or less. As noted above, with this election, the underwriting profit is not taxed at the federal level. However, investment income is fully taxed at the federal level and state premium taxes would also apply. Because many middle market companies are privately held businesses, these captives can become attractive tax and estate planning tools for the high wealth individuals behind those businesses. The Internal Revenue Service (IRS) is looking at these arrangements to see whether the pricing of the risk was unreasonably too high as a way to maximize the $1.2 million premium deduction and whether they meet all the criteria to be treated as an insurance company for federal tax purposes.

Due to the size of these middle market businesses, very few are multinational enterprises (MNEs). Therefore, few or no intercompany transfer pricing issues are encountered as these captives insure mostly US domiciled risks and are generally created by US taxpayers that pay US income taxes. We raised this topic in the paper by way of information and not as an item that is materially affected by the OECD Action Plan.

Not only is pricing of risk relevant for small captives, all captives theoretically have the opportunity to manipulate premiums due to related-party relationships and the subjective nature of the risks insured. The estimate for loss and loss expense reserves is likewise subjective and provides an opportunity for a captive to manipulate its deductions. Both of these risks can be mitigated through the use of qualified third-party service providers and many of the other topics mentioned throughout this report. Keep in mind that the information received from a third party service is only as good as the data given to the provider. It’s important to ensure the integrity of the data given and make sure appropriate safeguards are in place for validating the data.

Another area where captives can be accused of abusing tax efficiencies is by loaning a significant amount of cash to its parent or affiliates. This could be particularly abusive when the captive is a foreign entity in a jurisdiction that has low or no taxes. The interest payments from the parent could be deducted in full while the income to the captive goes relatively tax free. A parallel can be drawn to Action 4 in the OECD Action Plan related to interest deductions and other financial payments. Specific attention should be given to the terms and interest rates in the agreement to ensure these are at arm’s-length. Loaning money back to the parent or its affiliates can be a useful tool that provides true investment return. However, the lender must show they are treating the loan in the same manner as a commercial loan with an independent third party. Further, careful consideration

should be given to ensure the financial arrangement does not jeopardize the captive's insurance position. If the loan is significant, it could be viewed effectively as a return of capital.

Another area where a captive could abuse its tax efficiency is in manipulating its corporate structure and premium allocation in order to achieve sufficient risk distribution. The risk distribution criterion is at the heart of nearly all court cases involving captives. Captive owners should pay careful attention at formation, and when considering any corporate restructuring, to how the captive relates to the separate legal tax structure of the entire organization. Incorporating more third-party risk in the captive's program will help reduce this risk.

Summary —Many of the issues raised in the OECD report related to captives can be correlated in one way or another to the captive's insurance operations. If sufficient and routine consideration is given to the assessment of the captive's tax position, this could mitigate or resolve many of the OECD's concerns. Establishing a formal documentation process that addresses the various aspects as mentioned in this paper is very important and will result in increased transparency. Clearly outlining how the captive has considered the arm's-length concept, use of qualified third-party service providers, sound actuarial techniques and significant federal and state regulatory oversight will prove the necessary due diligence to comply with IRS, OECD and other foreign regulatory regime requirements.

Current tax code exists in the US to address concerns related to transactions with foreign entities with ties to US shareholders. Many foreign captives insuring US risks have considered or should consider the 953(d) election to avoid complexity and costly expense to comply with the CFC rules. These rules have been designed to help prevent some of the same concerns raised by the OECD.

APPENDIX

OECD Action Plan

ACTION 1 —Address the tax challenges of the digital economy
Identify the main difficulties that the digital economy poses for the application of existing international tax rules and develop detailed options to address these difficulties, taking a holistic approach and considering both direct and indirect taxation. Issues to be examined include, but are not limited to, the ability of a company to have a significant digital presence in the economy of another country without being liable to taxation due to the lack of nexus under current international rules, the attribution of value created from the generation of marketable location-relevant data through the use of digital products and services, the characterization of income derived from new business models, the application of related source rules, and how to ensure the effective collection of VAT/GST with respect to the cross-border supply of digital goods and services. Such work will require a thorough analysis of the various business models in this sector. A report identifying the issues and possible actions to address them will be issued. [September 2014]

ACTION 2 —Neutralize the effects of hybrid mismatch arrangements
Develop model treaty provisions and recommendations regarding the design of domestic rules to neutralize the effect (e.g. double non-taxation, double deduction, long-term deferral) of hybrid instruments and entities. This may include: (i) changes to the OECD Model Tax Convention to ensure that hybrid instruments and entities (as well as dual resident entities) are not used to obtain the benefits of treaties unduly; (ii) domestic law provisions that prevent exemption or non-recognition for payments that are deductible by the payor; (iii) domestic law provisions that deny a deduction for a payment that is not includible in income by the recipient (and is not subject to taxation under controlled foreign company (CFC) or similar rules); (iv) domestic law provisions that deny a deduction for a payment that is also deductible in another jurisdiction; and (v) where necessary, guidance on co-ordination or tie-breaker rules if more than one country seeks to apply such rules to a transaction or structure. Special attention should be given to the interaction between possible changes to domestic law and the provisions of the OECD Model Tax Convention. This work will be co-ordinated with the work on interest expense deduction limitations, the work on CFC rules, and the work on treaty shopping. [September 2014]

ACTION 3 —Strengthen CFC rules
Develop recommendations regarding the design of controlled foreign company rules. This work will be co-ordinated with other work as necessary. [September 2015]

ACTION 4 —Limit base erosion via interest deductions and other financial payments
Develop recommendations regarding best practices in the design of rules to prevent base erosion through the use of interest expense, for example through the use of related-party and third-party debt to achieve excessive interest deductions or to finance the production of exempt or deferred income, and other financial payments that are economically equivalent to interest payments. The work will evaluate the effectiveness of different types of limitations. In connection with and in support of the foregoing work, transfer pricing guidance will also be developed regarding the pricing of related party financial transactions, including financial and performance guarantees, derivatives (including internal derivatives used in intra-bank dealings), and captive and other insurance arrangements. The work will be coordinated with the work on hybrids and CFC rules. [September 2015]

ACTION 5 —Counter harmful tax practices more effectively, taking into account transparency and substance

Develop recommendations regarding best practices in the design of rules to prevent base erosion through the use of interest expense, for example through the use of related-party and third-party debt to achieve excessive interest deductions or to finance the production of exempt or deferred income, and other financial payments that are economically equivalent to interest payments. The work will evaluate the effectiveness of different types of limitations. In connection with and in support of the foregoing work, transfer pricing guidance will also be developed regarding the pricing of related party financial transactions, including financial and performance guarantees, derivatives (including internal derivatives used in intra-bank dealings), and captive and other insurance arrangements. The work will be coordinated with the work on hybrids and CFC rules. [September 2014 and December 2015]

ACTION 6 —Prevent treaty abuse

Develop model treaty provisions and recommendations regarding the design of domestic rules to prevent the granting of treaty benefits in inappropriate circumstances. Work will also be done to clarify that tax treaties are not intended to be used to generate double non-taxation and to identify the tax policy considerations that, in general, countries should consider before deciding to enter into a tax treaty with another country. The work will be coordinated with the work on hybrids. [September 2014]

ACTION 7 —Prevent the artificial avoidance of PE status

Develop model treaty provisions and recommendations regarding the design of domestic rules to prevent the granting of treaty benefits in inappropriate circumstances. Work will also be done to clarify that tax treaties are not intended to be used to generate double non-taxation and to identify the tax policy considerations that, in general, countries should consider before deciding to enter into a tax treaty with another country. The work will be coordinated with the work on hybrids. [September 2015]

ACTIONS 8, 9, 10 —Assure that transfer pricing outcomes are in line with value creation

ACTION 8 – Intangibles

Develop rules to prevent BEPS by moving intangibles among group members. This will involve: (i) adopting a broad and clearly delineated definition of intangibles; [September 2014] (ii) ensuring that profits associated with the transfer and use of intangibles are appropriately allocated in accordance with (rather than divorced from) value creation; [September 2014] (iii) developing transfer pricing rules or special measures for transfers of hard-to-value intangibles; [September 2015] and (iv) updating the guidance on cost contribution arrangements. [September 2015]

ACTION 9 – Risks and capital

Develop rules to prevent BEPS by transferring risks among, or allocating excessive capital to, group members. This will involve adopting transfer pricing rules or special measures to ensure that inappropriate returns will not accrue to an entity solely because it has contractually assumed risks or has provided capital. The rules to be developed will also require alignment of returns with value creation. [September 2015]

ACTION 10 – Other high-risk transactions

Develop rules to prevent BEPS by engaging in transactions which would not, or would only very rarely, occur between third parties. This will involve adopting transfer pricing rules or special measures to: (i) clarify the circumstances in which transactions can be re-characterized; (ii) clarify the application of transfer pricing methods, in particular profit splits, in the context of global value chains; and (iii) provide protection against common types of base eroding payments, such as management fees and head office expenses. [September 2015]

ACTION 11 – Establish methodologies to collect and analyze data on BEPS and the actions to address it

Develop recommendations regarding indicators of the scale and economic impact of BEPS and ensure that tools are available to monitor and evaluate the effectiveness and economic impact of the actions taken to address BEPS on an ongoing basis. This will involve developing an economic analysis of the scale and impact of BEPS (including spillover effects across countries) and actions. [September 2015]

ACTION 12 – Require taxpayers to disclose their aggressive tax planning arrangements

Develop recommendations regarding the design of mandatory disclosure rules for aggressive or abusive transactions, arrangements, or structures, taking into consideration the administrative costs for tax administrations and businesses and drawing on experiences of the increasing number of countries that have such rules. The work will use a modular design allowing for maximum consistency but allowing for country specific needs and risks. One focus will be international tax schemes, where the work will explore using a wide definition of "tax benefit" in order to capture such transactions. The work will be coordinated with the work on co-operative compliance. It will also involve designing and putting in place enhanced models of information sharing for international tax schemes between tax administrations. [September 2015]

ACTION 13 – Re-examine transfer pricing documentation

Develop rules regarding transfer pricing documentation to enhance transparency for tax administration, taking into consideration the compliance costs for business. The rules to be developed will include a requirement that MNE's provide all relevant governments with needed information on their global allocation of the income, economic activity and taxes paid among countries according to a common template. [September 2014, Discussion Draft issued January 2014]

ACTION 14 – Make dispute resolution mechanisms more effective

Develop solutions to address obstacles that prevent countries from solving treaty-related disputes under MAP, including the absence of arbitration provisions in most treaties and the fact that access to MAP and arbitration may be denied in certain cases. [September 2015]

ACTION 15 – Develop a multilateral instrument

Analyze the tax and public international law issues related to the development of a multilateral instrument to enable jurisdictions that wish to do so to implement measures developed in the course of the work on BEPS and amend bilateral tax treaties. On the basis of this analysis, interested Parties will develop a multilateral instrument designed to provide an innovative approach to international tax matters, reflecting the rapidly evolving nature of the global economy and the need to adapt quickly to this evolution. {September 2014 and December 2015]

CICA Transfer Pricing Work Group

Chair
Ian Kilpatrick, Founder/Director
Advantage Insurance Holdings, Ltd. Grand Cayman

History
Michael Bemi, CPCU, ARM, ARe
Director/President & CEO
The National Catholic RRG, Inc. Lisle, Illinois

Coherence
Jeremy Huish, CPA, JD, LL.M
Senior Vice President Business Development
Artex Risk Solutions, Inc. Mesa, Arizona

David Chaney, PwC Director
PricewaterhouseCoopers Phoenix, Arizona

Substance
Bill Bartlett, FCAS, MAAA
Principal & President
Bartlett Actuarial Group, Ltd. Charleston, South Carolina.

Joel Chansky, FCAS, MAAA
Consulting Actuary
Milliman, Inc. Wakefield, Massachusetts

Transparency
Dan Gregor, CPA, Tax Partner
Katrina Cohen, CPA, Senior Tax Manager
Saslow Lufkin & Buggy, LLP Simsbury, Connecticut

Taxation
Magali Welch, CPA, CA, AIAF, Partner, and
Matt Gravelin, CPA, Senior Manager
Johnson Lambert LLP Burlington, Vermont

Captive Insurance Companies Association
Dennis P. Harwick, JD, President, Pompano Beach, Florida
Ione Terrio, Minneapolis, Minnesota.