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The OECD Transfer Pricing Guidance on Financing Transactions: Captive Insurance Arrangements

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On 11 February 2020, the OECD published its final Transfer Pricing Guidance on Financial Transactions, as an amendment to the OECD Transfer Pricing Guidelines.[1] This guidance covered a range of financing arrangements, including captive (re) insurance. This paper provides some of the key considerations covered pertaining to captive (re) insurance.

The most important point made in the new guidance is that the OECD requires a comprehensive analysis of the commercial and financial relations among the parties involved in a transaction. Furthermore, such an analysis should consider the options realistically available to both parties. This means that one should understand the roles and responsibilities of the various entities, and their contributions to the overall value creation process, including the financial dealings amongst the entities.

The requirements to delineate a financial transaction appropriately also apply to captive insurances and reinsurances companies. To delineate the economically relevant risks associated with issuing insurance policies, the OECD acknowledges the relevance of Part IV of the report on the Attribution of Profits to Permanent Establishments.[2] In this respect, it is important to consider where the control functions are being conducted and if the captive has the relevant financial capacity to assume the relevant risks. Typically, these risks may relate to insurance risk, commercial risk, or investments risk, amongst others. If the captive does not have the appropriate skills or expertise to exercise the control functions, the return derived from the investment of premiums should be allocated to whichever member in the group exercises the control functions.[3]

The OECD further highlights that a critical item to consider is the question of whether a risk exists and, if so, whether a transfer of risk to the captive insurer has occurred. In this respect, the guidance provides a checklist on whether a risk exists and, if so, whether it is allocated to the captive insurance company in light of the facts and circumstances. It is further stressed that these insurance risks can only be assumed by the captive, if it can realistically be expected to satisfy the claims in the event of the risks materialising (i.e., the captive needs access to sufficient funding to bear the consequences of the risks materialising). If a captive insurance company were to invest the premiums into insured entities within the MNE group, the relation between the captive insurance company to satisfy the claim and the financial position of the group entities would become a key consideration as part of assessing the delineation of the transaction.[4]

It is also important to assess whether risk diversification (internal or external) occurred. The conclusion of the analysis would be dependent upon the specific facts and circumstances of the case and can have direct implications not only regarding the remuneration of a captive but also on whether a captive should be treated as a business other than an insurance business.

Finally, the OECD outlines several methods to determine the arm's length price of captive insurance and reinsurance.[5] Typically, when applying these methods, it is important to consider the economically relevant characteristics of the transaction[6]—including contractual terms, functional analysis, characteristics of the instrument itself, economic circumstances, and business strategies—and, to the extent needed, perform necessary adjustments to accommodate for differences. The pricing methods discussed include:

- A comparable uncontrolled price (CUP) method, which would include transactions involving already placed comparable insurance products by third parties;

- The actuarial method, which is a technical method that estimates the premium based on expected losses, underlying cost associated of managing the policy, and a profit margin; or

- The transaction net margin method (TNMM) using a combined ratio or return on capital ratios. This method typically entails comparing the captive insurance company claims and expenses relative to premiums (the combined ratio) and the operating profit relative to the captive capital (the return on capital) to the ratios observed on comparable insurance companies.

Given that captive (re) insurance companies may have significantly lower levels of expenses and differing capital requirements from commercial insurance companies, adjustments are often needed when applying the methodologies described above.

Regarding the use of opinions on premium prices that insurance companies could issue, it is likely that such an approach would not be compliant with the OECD guidance. In fact, when dealing with financing, the OECD specifically states that bank opinions on financing represent a departure from arm's length as they are not based on a comparison with an actual transaction.[7] The same argument can be deemed relevant for captive insurance companies.

Conclusion

For the first time, the OECD is providing direct guidance on how to deal with captive (re) insurance arrangements. The main element highlighted by the OECD is to perform comprehensive analysis of the commercial and financial relations among the parties involved in the transaction, with special consideration of issues such as whether a risk transfer has occurred and the extent of risk diversification. These analyses would not only affect the pricing of the transaction, but also the conclusion if the captive insurance company is in fact operating as an insurance company rather than another form of business. Such analysis is an essential driver to analyse the nature of the related party transactions being evaluated and the method that can be relied upon to price this transaction.

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NERA experts can perform detailed reviews of your intercompany financing arrangements to determine if your documentation is compliant with the regulatory guidance.
The standard of our independent advice has strengthened our reputation with tax authorities, and we have substantial experience in assisting clients with financing arrangements in the context of tax controversy proceedings and documenting controlled transactions to manage tax risk.

Notes

1 OECD (2020), *Transfer Pricing Guidance on Financial Transactions: Inclusive Framework on BEPS Actions 4, 8-10*, OECD, Paris, www.oecd.org/tax/beps/transfer-pricing-guidance-on-financial-transactions-inclusive-framework-on-beps-actions-4-8-10.htm.

2 OECD, *Attribution of Profits, to Permanent Establishments*, Part IV, 22 July 2010.

3 OECD (2020), Transfer Pricing Guidance on Financial Transactions: Inclusive Framework on BEPS Actions 4, 8-10, OECD, Paris, www.oecd.org/tax/beps/transfer-pricing-guidance-on-financial-transactions-inclusive-framework-on-beps-actions-4-8-10.htm, E2.2 and E2.3, pp. 38 and 39.

4 *Ibid*., E2, pp. 36 and 37.

5 *Ibid*., E3, pp. 39 and 40.

6 *Ibid*., B3, pp. 10–12.

7 *Ibid*., C.1.2.6, p. 22.

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