Deloitte.

# Captive insurance: Time to rethink

## Tax implications for captive insurance

## COVID-19 highlights value of captives

- COVID-19 has highlighted some of the potential commercial benefits of using captive insurance and reinsurance arrangements and the important role captive insurance companies can play as a risk mitigation tool. For example, some captives are paying out claims on risks groups are exposed to such as contingency risks, given third party insurance policies could exclude claims which relate to pandemics such as COVID-19.
- Captive insurance companies, created and wholly owned by non-insurance groups, pool risks and can be a cost-effective means of obtaining insurance. However, tax authorities often scrutinise captive insurance arrangements, particularly captives with outsourced operating models and low headcount and / or supported by onshore risk management functions and therefore it is important that the tax position is considered at the outset and is kept under review.

## Operating model design

- Where should the captive insurance company be tax resident? This doesn't necessarily need to be the same place as where it is established.
- If the captive is resident outside of the UK but supported by risk management functions in the UK, this may create a permanent establishment (ie taxable presence) risk in the UK.
- Controlled foreign company (CFC) rules may apply to tax the profits arising in an offshore captive in the parent jurisdiction. For the UK's CFC rules, consideration should be given to whether premiums are received from UK contracts, whether there are any UK significant people functions and whether the captive is overcapitalised.
- The UK's diverted profits tax (DPT) which seeks to tax profits artificially diverted from the UK at a punitive rate of 25%, can apply to intragroup captive insurance arrangements. HMRC's DPT guidance contains an example of a captive insurance arrangement where there are no commercial motives for the transaction other than the tax saving, concluding that a DPT charge arises.
- Economic substance rules have been introduced in a number of low-tax jurisdictions. These can require a minimum level of substance in that jurisdiction.

## Tax treatment of insurance premiums

- Transfer Pricing Guidance on Financial Transactions released in February 2020 (OECD 2020 TP guidance) provided specific guidance, for the first time, on the transfer pricing of captive insurance arrangements.
- Updates to the OECD Transfer Pricing Guidelines in 2017 introduced the potential to disregard transactions for tax purposes if 'commercially irrational' with a specific captive insurance example.
- Insurance Premium Tax (IPT) remains an area of focus for tax authorities, and can be impacted by pricing changes. IPT is an underlying cost and the UK rate has increased over recent years.

## Why Deloitte & how can we help you?

Captive owners should be prepared to face increased tax authority scrutiny over the coming years. We have a multi-disciplinary team of actuaries, tax and transfer pricing specialists with deep experience in advising on captives across a wide variety of businesses and industries. We can perform an initial review of your existing operating model to assess its substance and potential tax risk exposure and make recommendations in relation to a "best practice" operating model to meet your needs based on our practical experience, alongside assisting with transfer pricing documentation support.

## Five tax points to consider

1. Under the OECD 2020 TP guidance, captive insurance arrangements must be accurately delineated as actual insurance in order to be priced as insurance, or premiums may be disallowed. For this accurate delineation as insurance to take place, six criteria, including functional substance and risk transfer, must be met. Consider the following:

- The capability of staff in your captive – do they have the requisite functional capability and can they make decisions independently?
- Is the captive transaction genuinely one of insurance, i.e. is there a real transfer of risk to the captive?

2. Revisit the transfer pricing of intercompany insurance premiums. The OECD 2020 TP guidance sets out accepted transfer pricing methods for captive insurance.

3. Intercompany captive arrangements must be commercially rational or risk being derecognised or restructured for tax purposes, or subject to the UK's DPT. Consider and document the commercial rationale for the captive including:

- Why was the captive set up? And why is it still used?
- Does the captive pool risks?
- Does the captive purchase reinsurance?
- Is the insurance legally required?
- How does the use of the captive align with the risk management and capital management strategy of the business?
- Can the financial (non-tax) benefits of the captive be quantified?

4. Consider the existing operating model. Are operating guidelines required to manage any permanent establishment or tax residence risk? Have CFC rules been considered and is the group compliant with any relevant economic substance rules?

5. Consider the IPT position of current arrangements and any potential changes, for insurance premiums associated with EU risk. Location of risk and IPT has been placed under HMRC scrutiny in recent years – is offshore risk correctly identified as such for IPT accounting purposes?

## Connect with us:


Insurance Tax Specialists

Partner
Murray Mclaren
+44 (0) 131 535 7738

Associate Director
Hannah Simkin
+44 (0) 20 7303 4472

Transfer Pricing Specialists

Partner
Sebastian Ma'ilei
+44 (0) 20 7007 1596

Director
Jeremy Brown
+44 (0) 20 7007 5350

Director
Luka Pillai
+44 (0) 20 7007 5774

Actuarial Specialists

Director
Stavros Martis
+44 (0) 20 7303 0398

Senior Manager
Ben Gilman
+44 (0) 20 7007 3877