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Tax authorities tighten up on captive arrangements

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Tax authorities are stepping up their activities in the captive arena, according to captive tax experts speaking at the recent European Captive Forum.


Salil Bhalla, Head of Global Fronting, EMEA, AIG Europe

Loic Webb-Martin, Partner at PwC, said that there has been an increase in the number of tax authority challenges, typically in the jurisdiction of the insured, across a range of sectors and geographies.

He added that there has also been a lot of change on the legislative side, including the introduction of specific tax rules. He said this was all part of a wider programme of tax authorities focusing on captives in a much more sophisticated way. In the next 18 months, he expected more changes, such as the OECD's moves against base erosion and profit shifting by multinationals.

A few companies are re-evaluating whether they want to operate a captive as a result, though most clients, he said, are examining how they can re-organise their captive, essentially putting in more substance, either financial or human, and looking at how they can explain their captive arrangements more compellingly. Alternatively, some clients are looking to ramp up their captive arrangements, by putting more risk finance through their captive, he explained.

Mr Webb-Martin's colleague, Caroline Goemaere, Partner, PwC, stressed the importance of 'substance' in a captive, looking at the commercial drivers, the value contribution of the captive, documentation, and the governance framework.

The comments came in a presentation with the comprehensive title: 'Arm's Length, Fronting Issues, Transfer Pricing and Taxation.'

On the issue of market pricing, Mr Webb-Martin said there are a couple of options for captive owners. He said the first is where there is a market transaction that can then justify the internal pricing, although the challenge is proving that the two are on identical terms and levels of deductibles etc, or explaining why there is a difference.

The other option, he said, is the most common in the market, which is to look at the return on capital for the captive, which these days, he said, requires quite a sophisticated analysis.

Salil Bhalla, Head of Global Fronting, EMEA, AIG Europe, noted: "The loss ratios of our clients show that the captives generally perform pretty well compared with the commercial insurance market, so they are already operating at levels where the commercial insurance market would generally be quite envious.

But, he explained, arguably, no-one would introduce their captive to their insurance programme to increase the cost of insurance. "So there is a challenge there, but captives are trying to establish a rate that is not costing the original insured more than they would get in the commercial market," he said, adding: "It is a conundrum."

Donenica Ulrich, Head of Global Captive Product Underwriting, Zurich, said that the insurer looked at each fronting transaction to see whether it thinks the price that is ceded to the captive is in line with market practice. "In Europe, most of the transactions are net retained cessions. So the risk is often retained by the captive. So in these cases, the pricing is quite easy," she said. "Some customers tell us clearly that they have pressure from their subsidiaries not to offer too high prices to the subsidiaries because otherwise they will try to get out of the programme."

Mr Bhalla said that transfer pricing is a particular concern when the captive is part of a multinational programme. "Pricing on a controlled master programme will never be the sum of all the local policies. So if for benchmarking purposes you asked every country to price that risk, and add it all up, invariably it will be more than the total programme premium charged. So there will always be a difference there," he said.

He went on: "You are more likely to be questioned about pricing at the local country level, so you have the challenge of delivering savings from a controlled master programme against what you would be paying if you arranged your insurances in every country on an individual basis. Then there are the traditional economies of scale that come from the captive accessing the reinsurance market, so you are almost comparing retail prices with wholesale prices."

He concluded: "So this is never a straightforward issue, but one where being 'reasonable' is very much the key, and trying as much as possible to align the pricing with what would be available in the market."

Also on the panel was Jochen Boehm, Director of Corporate Insurance at Deukona, Deutsche Bank's in-house captive broker, who explained that Deutsche Bank's captive was one of the key elements of its global insurance programme which is largely liability-related and crime-related. He said that the captive was a good instrument to have in order to help to ensure that the programme is structured efficiently and properly, covering the lower part or the frequency part of the risk.

He explained that if an organisation has very different risk profiles within the group, it is necessary to provide an adequate deductible to all legal entities, and the captive had an important role to play in this. In addition, he pointed out, the captive allowed the group to have direct access to the reinsurance markets.