Actuarial and transfer pricing support – a brief insight on a captive structure's documentation standard

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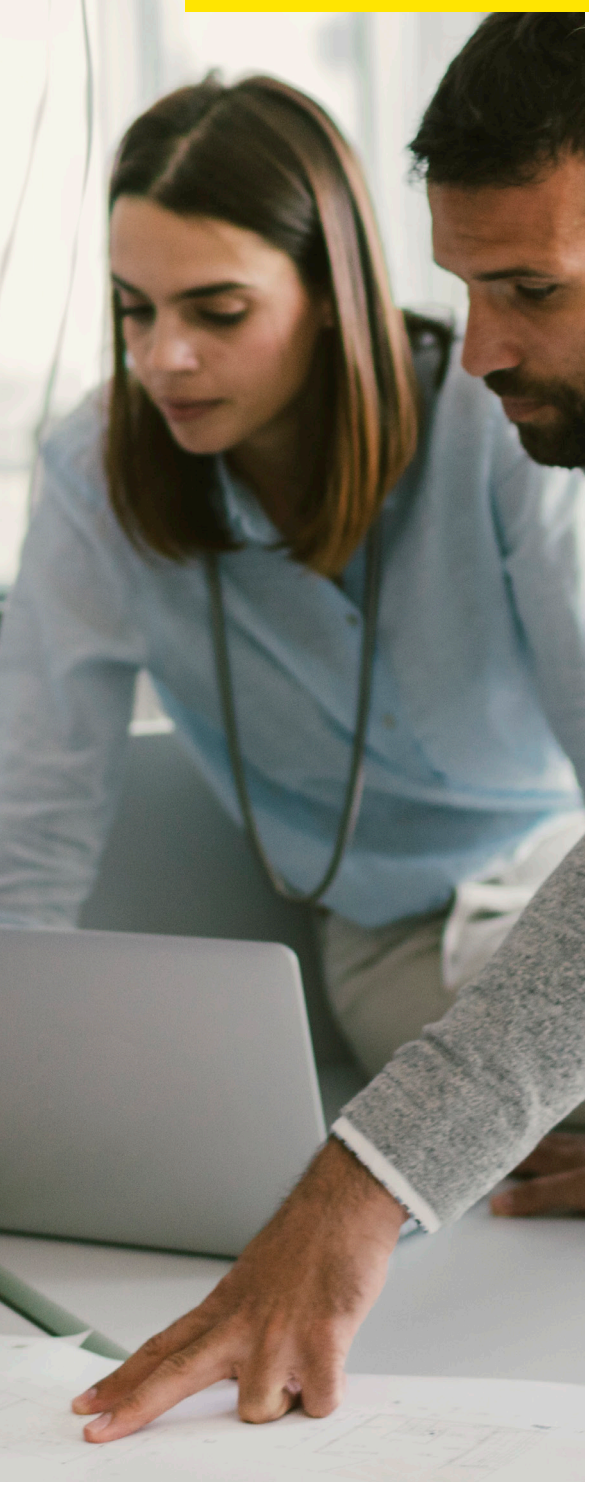
Actuarial analysis has long been viewed as overlapping with transfer pricing analysis for captive insurance pricing. In fact, numerous recent court cases highlight the need for actuarial analysis to demonstrate the arm's-length nature of a captive insurance transaction. Moreover, the release of the first public discussion draft on the transfer pricing aspects of financial transactions (the discussion draft) by the Organisation for Economic Co-operation and Development (OECD) on 3 July 2018 underscores the need for a taxpayer with a captive to reconsider how the actuarial analysis is used and to identify additional transfer pricing considerations to support its premium pricing.



Finding insurance

Years ago, in Gulf Oil Corp. v. Commissioner, the US Tax Court (tax court) endorsed the notion that a captive that insures one or more unrelated parties may be able to provide insurance to its affiliates. As explained in Gulf, when a captive pools a "substantial proportion" of unrelated risks and premiums with risks and premiums of its affiliates, it causes the premiums of the affiliated group to be insufficient to cover the anticipated losses of all of the insureds. In turn, this means "the members of the affiliated group must necessarily anticipate relying on the premiums of the unrelated insureds in the event that they are 'the unfortunate few' and suffer more than their proportionate share of the anticipated losses." Such pooling of related and unrelated risks and premiums provides the risk distribution that enables a captive's affiliates to shift the insurance risk to the captive. The tax court observed, however, that for unrelated insurance business written by a captive to provide the risk distribution necessary to permit a captive's affiliates to shift the risk to it, the premiums paid by each insured (both related and unrelated) need to be determined by reference to an actuarial estimation of the risk of loss.

In two relatively recent cases, Rent-A-Center, Inc. v. Commissioner and Securitas Holdings, Inc. v. Commissioner, the tax court held for the taxpayers and concluded that their captives (neither of which insured unrelated parties) provided insurance to affiliates. In each case, the tax court specifically found that the insurance contracts between the captives and their affiliated insureds were issued and implemented at arm's length and the premiums charged for them were determined by actuarial analysis and loss forecasts, which, coupled with the fact that each captive insured a significant number of statistically independent risks and, thus, had risk distribution, supported a conclusion that insurance existed. But in its most recent captive insurance opinions, Avrahami v. Commissioner and Reserve Mechanical Corp. v. Commissioner, cases in which each captive reinsured unrelated pooled risk ceded to it by a non-US reinsurer to obtain the required risk distribution, the tax court disagreed with the taxpayers' claims that the actuarial analysis of the risk of loss drove the pricing of the premiums. In both cases, the tax court found that premium pricing was designed to permit the captive to claim it derived at least 30% of its premiums from unrelated parties (a threshold for unrelated business suggested by the tax court's 1991 opinion in Harper Group v. Commissioner). In the view of the tax court, even with the input of actuaries, the pricing of the pooled risk did not reflect actuarially estimated loss projections. In addition, in both Avrahami and Reserve, the tax court found that the contracts between the captive and its insureds were not issued or enforced at arm's length, due in part to the captive failing to reflect the varying nature and scope of the risk in its underwriting. And in both cases, the tax court found that the reinsurers that accepted risk from the captives and then ceded the pooled risk to the captives were not "bona fide" insurance companies, in large part due to the fact that each such pooling company reinsured and then ceded little actual risk (at least as revealed by claim experience), yet received and paid significant premiums.

Enter the OECD

Echoing the baseline question asked by the tax court in its captive insurance cases, the OECD's discussion draft starts with a question about whether the transaction is genuine insurance. Despite claiming that prescriptive definitions of insurance are beyond the scope of the discussion draft, it provides six indicators of insurance typically present in unrelated insurance transactions. The first indicator looks for diversification and pooling of risk. Unsurprisingly, this dovetails with a key indicia of insurance (risk distribution) used by the tax court to find insurance and, as the aforementioned cases make clear, it is where actuarial analysis is helpful.

In addition to supporting risk distribution, actuarial analysis may also assist with determining whether the captive has a "real possibility" of suffering losses, another indicator of insurance offered by the discussion draft (and apparently of great concern to the tax court in Avrahami and Reserve since, in each case, the tax court pointed to the lack of claims payments in determining that insurance did not exist). The discussion draft does not define the term real possibility, however, which suggests the application of this indicator to a captive accepting extremely high-severity but low-frequency risks may be less than straightforward.

Unfortunately, not all of the indicators suggested by the OECD may be supported by actuarial analysis. For example, whether the captive has the requisite underwriting skills and experience and how the captive is being regulated also are indicators of insurance suggested by the OECD (as well as by the tax court). The discussion draft also differentiates between the risk mitigation and risk control functions and the risk rewards for each. These considerations relate closely to the substance of the captive, the functions performed by the captive and the values that go with those functions, all of which are essential to determining the arm's-length pricing in captive insurance transactions. As discussed in the latest transfer pricing guidelines for multinational enterprises and tax administrations published in July 2017, and further confirmed in the discussion draft, arm's-length compensation typically reflects the functions that each party performs, taking into account the assets used and the risks assumed. It is, therefore, more important now than ever to prepare a functional analysis that identifies the economically significant activities and responsibilities undertaken, the assets employed and the risks assumed by each related party in relation to a captive.

Pricing methods

The tax court did not explicitly discussed transfer pricing in its recent captive insurance opinions, but the discussion draft outlines two approaches for determining an arm's-length premium in a captive insurance transaction — comparable uncontrolled prices (e.g., comparable arrangements between or with unrelated parties) and actuarial analysis. These approaches appear to be broadly accepted in different parts of the world, including the US. The different results in the tax court cases discussed above highlight the benefit of actuarial analysis to demonstrate the arm's-length nature of a captive transaction. Although the need for actuarial analysis in captive premium pricing seems acknowledged, the benefit of using comparables to price seems somewhat overlooked. Given the emphasis of comparables as a pricing method in the discussion draft and the appealing intuitive nature of this method to taxing authorities, it is wise for taxpayers with captive arrangements to consider and document the application of this method when setting premiums.

The discussion draft states that a comparable uncontrolled price can be arrived at by considering the arm's-length profitability of the captive in terms of underwriting profit and investment return, which suggests the OECD would apply this method to captive transactions, perhaps using a broader definition than before but not with a lower standard of comparability. For example, if the price previously charged by an independent insurer is used to support the premium charged by a captive, comparability factors such as lines of coverage, limits, deductibles, geographic market and economic circumstances should be considered. Differences in these factors that may affect the transfer price should be reflected. Adjustments also should be considered when profitability benchmarking is used, as echoed in the discussion draft. The OECD recognizes the differences in capital adequacy requirements and target credit ratings between a captive and a commercial insurer and asks that reasonable adjustments be made accordingly.

As both the tax court opinions and the discussion draft demonstrate, timely and professionally rendered actuarial and transfer pricing analyses should greatly strengthen a taxpayer's claim that its transactions with its captive insurer should be respected for tax and regulatory purposes.

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