THE RISKS AND THE REWARDS

IN TIMES OF SOARING INSURANCE PREMIUM RATES, IT MAKES GOOD SENSE TO FIND OUT WHETHER A CAPTIVE IS RIGHT FOR YOUR GROUP. **MARK DOWNEY** OF ERNST & YOUNG IDENTIFIES THE COMMERCIAL AND TAX ISSUES.

Following 11 September and the consequent hardening of insurance rates, many groups are looking at captive insurance companies as a way of managing down insurance costs, providing an increased return on capital and emphasising effective risk management in their businesses.

A captive insurance company is typically a wholly owned subsidiary whose business consists of insuring or reinsuring the risks of its fellow group members. Captives are often located in jurisdictions that have low levels of taxation, and such territories also tend to have an insurance regulatory regime that is less onerous than that in the UK. Typical bases for the captive insurers of UK groups are the Channel Islands or the Isle of Man, as well as the Cayman Islands, Bermuda and Gibraltar. The Republic of Ireland is also gaining ground as an attractive location for a captive insurance vehicle, particularly in the reinsurance market.

COMMERCIAL ADVANTAGES. There are many good reasons for setting up a captive insurance firm. They can be used to underwrite a wide range of the risks facing a group, either directly or by reinsuring a third-party insurer with whom the group initially places its business (known as 'fronting'). This may be a legal necessity as some types of business, for example, employers' liability, have, by law, to be written with a UK-regulated insurance company.

The primary benefit of having a captive insurance company in a group is a reduction in costs associated with the group's insurance programme. This comes about through the combination of a number of factors.

- The principle of insurance involves the pooling of risk. Policyholders with low claims rates therefore subsidise those which claim frequently or in large amounts. A captive insurance programme avoids this tainting.
- The captive is not so exposed to market forces as a third-party insurer and premium rates will typically remain more stable. Alternatively, the captive can smooth premium rates over time, so reduce volatility.
- Policies can be written that directly reflect the needs of the organisation rather than the one size fits all approach of the third party insurer.
- Most groups will have a number of low-level risks in which the claims made each year approximate closely in value to the premiums paid away. The third-party insurer will include a profit element in its premium for these risks despite the fact that its exposure to risk is negligible. Paying these premiums to a third party also involves a cashflow disadvantage compared with retaining the funds in the group through the mechanism of a captive.
- The captive will have direct access to the reinsurance market. Reinsurers do not have the administrative and sales infrastructures typical of an insurance company and therefore premium rates are lower. Reinsurance rates also tend to become cheaper more quickly as the insurance market softens.
- Some risks may be uninsurable to the extent that a third party would charge a premium out of all proportion to any likely claim. A captive is more likely to underwrite such risk and the use of captives to underwrite cover that is rarely available, if at all, in the open market is growing.
- An in-group captive focuses management attention on risk and offers potentially significant financial returns for good risk management. There is often a noticeable cultural change towards improved risk management in a group that owns a captive insurer.

A secondary benefit, but one that can be an important motivating factor for those with responsibility for managing corporate risk, is control: the ability to issue policies to subsidiaries and trading partners directly out of a company within the group means that data, information and influence is retained within the group and not given away to third parties.

Another benefit is that premiums paid to the captive remain within the company and the investment income thereon accrues to the benefit of the group.

There are a number of ways of accessing surplus funds in a captive of which an interest free up stream loan to a UK based group member is one of the easiest.

Finally, there may be tax savings if the captive can be structured in a way that minimises the effect of the UK's controlled foreign company rules or avoids them altogether.

'THE MOST OBVIOUS TRANSFER PRICING CHALLENGE TO A CAPTIVE INSURER WILL BE THAT THE PREMIUMS ARE IN EXCESS OF THOSE THAT WOULD BE PAID TO A THIRD PARTY'

TAX RISKS. Most captive insurance companies will be controlled foreign companies, which broadly are firms resident outside but controlled from the UK. The Inland Revenue's view is that such companies are a mechanism whereby a tax deduction is generated in the UK through the payment of premiums to the captive, while any underwriting profit and the investment income arising on the premiums accrues offshore, where it is taxed at low rates or not at all. There are accordingly a number of potential tax risks that need to be addressed when setting up a captive insurer.

RESIDENCE. It is important to establish the captive's management structure in such a way that the Inland Revenue cannot argue that the captive is resident in the UK for tax purposes. The Inland Revenue will examine whether the central management and control of the captive is exercised in the UK, rather than its place of incorporation, and, if so, it will be regarded as UK resident. An appropriately worded agreement with an overseas captive manger and a majority of external Board members will usually suffice to see off this argument. It is important to note, however, that the Inland Revenue will consider the substance of what actually takes place, as opposed to the form of the management arrangements. The captive will need to demonstrate independence from the owning group.

CONTROLLED FOREIGN COMPANY LEGISLATION. The UK tax legislation contains provisions that were introduced to counter tax avoidance by the transfer of profit-making activities to low tax jurisdictions, which are defined as territories in which a company is subject to a level of taxation that is less than 75% of the corresponding UK tax on its profits.

A UK-controlled company located in a low tax jurisdiction may, under this legislation, be required to attribute its current profits to its UK parent company for the purpose of determining the parent company's UK taxable profits.

A controlled foreign company can avoid its profits being taxable on the UK parent under the legislation if it can satisfy one of the following statutory tests:

- that its chargeable profits for the accounting period do not exceed £50,000;
- the motive test;
- the acceptable distribution test; or
- the exempt activities test.

Each test is considered separately for each accounting period of the controlled foreign company, and it is possible to meet, or fail to meet, any of the tests in different accounting periods.

The £50,000 *de minimis* exemption is a question of fact. Under the controlled foreign company rules the captive will need to calculate its chargeable profits as if it were a UK resident insurance company.

The motive test applies when it is not the main reason, or one of the main reasons, for the controlled foreign company's existence (or for any of the transactions the results of which are reflected in its accounts) to achieve a reduction in UK tax by a diversion of profits from the UK. In practice, it is rare for the Inland Revenue to accept that a captive insurer can meet the motive test.

The acceptable distribution test requires a controlled foreign company to pay a dividend of 90% of its chargeable profits, calculated as if it were a UK resident insurance company, to its UK parent within 18 months of the end of the accounting period. This will confer a short-term timing advantage, although a newly established captive may struggle to find the necessary level of distributable reserves, particularly if its taxable profits exceed its accounting profits. Depending on the accounting dates of the captive and its parent, payment of UK tax on the dividend may be deferred for up to two years.

In broad terms, the exempt activities test allows certain categories of business to fall wholly outside the scope of the controlled foreign company legislation if the captive fulfils certain requirements that establish its tax residence outside the UK.

A company which is mainly engaged in financial business (which includes long-term and general insurance business) will be exempt if less than 50% of the gross trading receipts of that particular business are derived directly or indirectly from connected or associated persons.

If it can be established that the captive meets the requirements of the exempt activities test, it may be able to take the whole of the group's insurance programme with the captive outside the controlled foreign company rules.

The 2002 Finance Bill includes a clause that will allow HM Treasury to bring a resolution before Parliament disapplying the exemptions from the controlled foreign company rules to certain territories. These rules are designed to bring pressure on offshore havens to comply with OECD requirements and may have an adverse effect on an established captive in any territory so designated.

TRANSFER PRICING. When a UK company enters into a transaction with a connected party overseas, the profits or losses arising from the transaction must be calculated for UK tax purposes using an arm's length price – that is, the price that would have been paid by independent persons. This rule applies whether the UK company deals directly with the overseas connected party or through a third party.

The most obvious transfer pricing challenge to a captive insurer will be that the premiums are in excess of those that would be paid to a third party. Another possible threat comes if a UK group member introduces customers to the captive, most typically if the captive writes extended warranty or similar business. In such cases, the Inland Revenue may seek to impute a commission receipt in the hands of the UK company.

RELIEF FOR PREMIUMS PAID. Insurance premiums would normally qualify as a business expense on which tax relief is given. However, the Inland Revenue may challenge this treatment on the grounds that the premiums are not paid wholly and exclusively for the purpose of the paying company's trade. Typically, it will be argued that either the 'risks' being insured are negligible or the policies being written are such that the captive has insufficient resources to honour them should a claim arise.

The Inland Revenue may also argue that the premiums are contributions of capital to the captive and are therefore not allowable as deductions for tax purposes in the hands of the UK payer.

CHARGEABLE PROFITS. If it becomes necessary to calculate the chargeable profits of the captive for any reason, they will be calculated

as if it were resident in the UK. This means that it will need to take account of all tax legislation affecting UK companies, especially insurers.

In particular, legislation has recently been introduced in the UK that uses hindsight in taxing the reserves set aside by general insurance companies to meet future claims. In broad terms, the legislation provides for a comparison of the original reserve for each year to be compared with the discounted actual out-turn on a year-by-year basis.

Meeting the requirements of these rules will introduce an additional tax compliance burden in managing the captive. It is important to note that these issues will need to be addressed, whether the owning group accepts that its captive falls within the controlled foreign company rules or if it wishes the captive to pursue an acceptable distribution policy.

INLAND REVENUE REVIEW OF CAPTIVES' ACCOUNTS. Inspectors who specialise in the taxation of insurance companies review the accounts of all captive insurance companies sent to the Inland Revenue. They have access to the accounts of many captive insurers and will be able to compare the results of the captive with others writing similar business in the wider market. Inspectors also have access to an actuary who may be asked to advise in situations in which the amounts involved are significant.

The inspector is also likely to look at other issues, particularly concerning the way in which the captive recognises premium income and the validity of any funded basis of accounting that it uses.

INDIRECT TAXES. The supply of insurance or reinsurance is exempt from VAT, but a premium payable under a contract of insurance in respect of a risk situated in the UK carries Insurance Premium Tax.

REGULATORY ISSUES. Favoured offshore locations for captives have less onerous regulatory regimes than the UK, and capital and solvency requirements are also considerably lower. Accounts and regulatory returns are usually not documents of public record and are therefore not available to competitors.

Having established that the captive is regulated outside the UK, it is important to ensure that it does not carry on insurance business in the UK within the definition of the Financial Services and Markets Act 2000, since it is a criminal offence to carry on insurance business in the UK unless the firm is authorised to do so by the Financial Services Authority. In practice, a properly structured agreement and division of responsibility between the group and the captive's managers should ensure that regulatory problems are not encountered.

ACCOUNTANCY ISSUES. Implementation of FRS 12 has highlighted a number of issues in accounting for self-insurance arrangements, and the particular arrangements between the owning group and its captive will need to be considered in detail by the group's auditors. The fact that certain business is placed in the first instance through a fronting insurer will not change the analysis as the group still retains the risk.

A WAY TO INCREASE VALUE. There is no doubt that a captive insurance company can increase value to shareholders in several ways and the down-side tax risks are manageable. In times of ever-increasing insurance premium rates, it makes good commercial sense to investigate whether a captive is right for your group.

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