PRESENTATION

OECD BEPS PAPER ON FINANCIAL TRANSACTION

BY

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Background

- On 3 July 2018, the Organisation for Economic Co-operation and Development (OECD) released the first public discussion draft on the transfer pricing aspects of financial transactions (the Discussion Draft).
- A non-consensus document where the OECD is asking for input from commentators in a number of areas

Divided into four main areas:

- Interaction with the Guidance in section D.1 of OECD Transfer Pricing Guidelines
- Treasury functions, including
  - Intra-group funding
  - Cash pooling
  - Hedging
- Captives
- Guarantees

WHAT IS INSURANCE

- Starts by providing an overview of insurance through a reference to Part IV of the Report on the Attribution of Profits to Permanent Establishments
- List some of the key features, including, inter alia:
  - Presence of diversification and pooling of risks
  - Improvement of the economic capital of the group as a result of the diversification
  - Evidence of external insurance market for the covered risks
  - Existence of requisite skills (including underwriting skills) at the insurer, and
  - The possibility of losses

WHAT IS INSURANCE

- Goes on to address some of the commercial reasons for establishing a captive, including cost mitigation and gaining access to reinsurance markets.
- Acknowledges that the potential to insure against certain risks that are difficult or impossible to obtain coverage for in the market. However, it goes on to state that "where such risks are insured by a captive insurer this may raise questions as to whether an arm's length price can be determined and the commercial rationality of such an arrangement."

WHAT IS INSURANCE

- Draft makes it clear that fronting arrangements, whereby a third party insurer receives the premium from the MNE's local entities and reinsures the risk to the captive in return for a fronting fee, are controlled transactions and that the premium received by the captive should be appropriately transfer priced.

CAPTIVES – THE RISK OF RECHARACTERISATION?

- Before looking to establishing an arm's length price, the Draft states that it is necessary to understand whether the arrangements are truly insurance and whether the captive has assumed and is capable of controlling the insurance risk contractually transferred to it.
- Explicitly states that the paragraphs in the OECD TPG that concern the analysis of risk apply to insurance businesses in the same way as they apply to other businesses.

CAPTIVES – THE RISK OF RECHARACTERISATION?

- Provides two examples where the captive might not be carrying out insurance:
  - Financial capacity to assume risk and pay claims
  - Risk diversification, as the Draft questions whether a captive insurer within an MNE has the scale to achieve significant risk diversification
- Little further discussion as to when a captive may not be carrying out insurance business and the Draft asks for views from commentators

CAPTIVES – PRICING OF PREMIUMS?

- The Draft notes the potential to use third party pricing evidence for pricing premiums, although it highlights the need for a detailed analysis that is required to determine the need for and quantification of comparability adjustments – e.g. volume differences.
- Suggests that an actuarial analysis would be more appropriate. It breaks this down into two elements:
  - A combined ratio designed to ensure that the captive covers anticipated losses, underwriting and administrative costs; and
  - An investment return based on the return of capital.

CAPTIVES – PRICING OF PREMIUMS?

- The Draft goes on to suggest that a captive may need to make adjustments to both the capital level it holds compared to commercial insurers due to the capital constraints for a regulated insurer
- Similarly it highlights the need to consider the rate of investment return achieved by the captive to the extent it is investing in related party investments.

CAPTIVES – PRICING OF PREMIUMS?

- The Draft also considers two further specific scenarios:
  - Group synergies – similar to the discussion on cash pooling, where the members of the MNE come together to pool insurance risks through the captive to reduce the overall premiums, the Draft suggests that the benefit of the lower premiums should be shared amongst the insured companies.

CAPTIVES – PRICING OF PREMIUMS?

- Agency sales – the Draft addresses the scenario where an agent in the MNE group sells highly profitable insurance on behalf of a captive together with its own products (e.g. extended warranty insurance / mobile phone insurance). The Draft follows HMRC's logic in the Dixon's case that "the ability to achieve the very high level of profit on the sale of the insurance policies arises from the advantage of customer contact at the point of sale" and thus the captive should earn the benchmarked return for insurers insuring similar risks with the residual profit allocated to the agent.

THANK YOU

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