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UNOFFICIAL ENGLISH TRANSLATION

Transfer pricing, application of the arm's length principle and the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations

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9.2 Captives

9.2.1 Characterisation of the transaction

Within the group, certain entities act contractually as internal (re)insurers. These are hereafter referred to as captives.

To assess, within the framework of the characterisation process of these transactions, whether the captive insurance companies are in fact insurance companies, the following questions must be answered:

- Does diversification and pooling exist in the captives?
- Did the economic capital position of the group entities improve because of diversification?
- As a regulated entity, is the captive subject to rules relating to the actual assumption of risk and the capital required?
- Would the insured risk be insurable outside the group?
- Does the captive have the required expertise and experience in relation to the insurance business and the investment of the premiums received?
- Is there a real possibility that the captive will suffer losses?

To reach the conclusion that there are actual insurance transactions, all the above questions must, in principle, be answered in the affirmative.

As regards diversification, it should be considered that generally a captive insurance company has a lower degree of diversification than an external insurer insuring similar risks, due to its smaller circle of insured persons. In principle, a lower degree of diversification demands that the captive should charge a higher premium for assuming the insured risk. Without such a higher premium, the captive would not generate sufficient return to bear the risks incurred and to realise the remuneration for its risk capital.

A reduction of risk capital, possibly resulting in a lower premium, neither would make the insurance transaction possible from a rational economic perspective. This reduced capital would be insufficient to cover all the expected damages if the insured risks materialise, so that the insured persons would partly themselves assume the risk. The higher premium that would have to be charged from the captive's perspective, would make the insured entity better off by insuring the risks with an unrelated more diversified insurer. The insurance transaction with the captive will therefore not materialise in such a situation.

9.2.2 Insured risk and insurance risk

When analysing an insurance transaction, it is important to distinguish between:

i. the risk associated with insurance; and
ii. the insured risk.

In general, the insured is in control of the insured risk. After all, the decision to assume the risk and to insure against the negative consequences of that risk is part of the insured's control over that risk (see (i) and (ii) of section 1.61).

If there is actual insurance, the captive exercises a so-called 'risk mitigation function'. This is a function that does not belong to the control function regarding the insured risk (see (iii) of par. 1.61 and par. 1.65).

It must subsequently be established whether the captive is in control of the insurance risk. It is important to note that the OECD guidelines consider the "underwriting function" described in the OECD PE report as the control function about the insurance risk.

If the captive does not perform the described control functions, the risks must be allocated to the party that does. Also, the (net) proceeds from the invested premiums must in that case be allocated to that party (see section 10.212).

9.2.3 Passive pooling of insurance risks

In a so-called passive pooler, only group risks are pooled, or bundled and placed on with unaffiliated (re)insurers. In the former situation, this is often the excess that the group itself wishes to retain and/or to which it is obliged by external insurers. Usually, the passive pooler is an extension of the head office risk management department.

Such entity is usually forced to accept all insured within the group and is often prohibited from insuring risks of parties outside the group. It does not perform the underwriting function mentioned above, does not itself diversify and does not have the required expertise and experience in relation to the insurance activity and investment of the premiums received. Therefore, the requirements set out above to qualify the transactions as insurance transactions are not met. The entity performs mainly an administrative and/or intermediary function that justifies only limited remuneration.

The other benefits arising through this entity, such as the synergetic advantage that the group entities, combining their strengths, will have from centralised negotiations with potential (re)insurers and the investment proceeds generated by its premium income (see section 10.212).

9.2.4 Insurance as a by-product

There are situations where the insurance is offered as a by-product to buyers of products or services by a group with activities outside the insurance industry, such as a cancellation insurance or insurance for extended guaranty terms. Generally, the relevant customer policy is written by an unaffiliated insurer supervised by a local regulator. The premium, after deduction of a fee for the unrelated insurer, is passed on as the reinsurance premium to the internal affiliated reinsurer.

In practice, it is not the internal reinsurer, but the group entity carrying out the main business of the group, that offers the insurance as a by-product to the unrelated customer. That group entity achieves diversification through its customer base and thereby obtains the insurance benefits for the group. The internal reinsurer generally does not perform the underwriting function described above, neither does diversify itself nor does have the required expertise and experience in relation to the insurance activity and investment of the premiums received. Therefore, the requirements set out above for transactions between the internal reinsurer and the group entity pursuing the main business of the group to qualify as insurance transactions are not met. Such a body performs only a limited administrative function that justifies limited remuneration.

9.2.5 Sale of insurance through an agent

Section E.3.4 of Chapter X TPG describes the sale of insurance through an affiliated intermediary where the profit made by the insurer is higher than in comparable transactions with similar third parties. This only concerns a group company that, based on the criteria mentioned in section 9.5.1 of this decision, also actually provides insurance. In the example, high value technology products by a high street retailer are sold together with insurance providing damage and theft cover from an affiliated insurer. To determine the arm's-length

remuneration for the intermediary, particular attention must be paid to the circumstances that lead to excess profit on the insurance. If the excess profit is attributable to the point-of-sale opportunity because of the seller's direct contact with the customer, the (additional) benefit realised as a result should not be allocated to the affiliated insurer. In such a situation, the affiliated insurer should receive a remuneration equal to that of comparable non-affiliated insurers.