Base Erosion & Profit Shifting (BEPS):

Exploring why captive insurance companies are legitimate risk management solutions adding value to their owners

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Executive Summary

In the Organisation for Economic Co-Operation and Development's (OECD) Action Plan, BEPS is defined as follows*: "BEPS relates to arrangements that achieve no or low taxation by shifting profits away from the jurisdictions where the activities creating those profits take place or by exploiting gaps in the interaction of domestic tax rules where corporate income is not taxed at all. No or low taxation is not per se a cause of BEPS, but becomes so when it is associated with practices that artificially segregate taxable income from the activities that generate it. The important distinguishing characteristic of BEPS is tax planning strategies that result in a disconnect between the geographic assignment of taxable profits and the location of the underlying real economic activities that generate these profits."*

According to the *Business Insurance 2016 Captive Directory*, there are 6,939 captive insurance or reinsurance companies currently in operation globally.

These companies are genuine insurance or reinsurance undertakings which form an integral part of the risk management system of their owner, they are fully regulated by the insurance supervisory authorities in each jurisdiction, they are subject to governance and control requirements, and they are fully transparent. They also form an integral part of the worldwide insurance and reinsurance market and are fully supported by commercial insurers or reinsurers with whom they deal.

Consistently with our views, captive arrangements were also not listed as potential aggressive tax planning strategies and indicators in the recently published Final Report commissioned by the European Commission on "Structures of Aggressive Tax Planning and Indicators" (Working Paper N°61-2015). Based on OECD's BEPS reports and other tax literature, this report identifies seven models representing all major empirically proven channels for profit shifting: hybrid financing structures, hybrid entity structures, two-tiered IP structures, one-tiered IP structures, offshore loan structures, interest-free-loan structures, and patent-box structures. This report brings evidence that none of these structures relate to or involve captive arrangements.

To provide supporting facts, the following table provides a high level summary of what captives do and don't do against key BEPS objectives (please refer to the corresponding section of the document for more details):

BEPS Objectives	What captives are/are not	Supporting facts
"*tax planning strategies that result in a disconnect between the geographic assignment of taxable profits and the location of the underlying real economic activities that generate these profits*" (Action 11 §56)	They are a **genuine risk management strategic tool** for group companies, and are not driven by tax planning strategies	• Captives are recognised by the International Association of Insurance Supervisors (IAIS) as an "enterprise risk management" tool; • Captives are the only entities within a group which can consolidate operational risk exposures from all group entities; • Captives are the only entities that allow corporations to access higher levels of risk transfer capacity by accessing the commercial reinsurers; • The next best alternative for corporations would either be to increase risk transfer costs, or to increase vulnerability of operating units.
"*transfers of profits that are not in response to changes in the location of real economic factors, labour and capital*" (Action 11 §68) & "*domestic incentives designed to encourage artificial schemes without economic substance*" (Action 11 §83)	They are **not artificial structures**	• Captives are recognised by the Solvency II Directive and by the IAIS as an integral part of the global insurance/reinsurance market; • Captives are fully regulated entities, subject to risk-based governance and capital requirements under Solvency II and the IAIS Principles; • Captives effectively provide functions, risk, and capital, through decision making activities at Board/Committee level; • It would be non-economical for each captive to have full time staff given the few transactions, limited number of policies, low complexity, and require varied expertise. For these reasons, captive owners outsource the execution of the Board's decisions to professional insurance managers.
"*preferential regimes that are potentially harmful due to lack of transparency*" (Action 5 §20-21)	They are **fully transparent structures**	• Captives are subject to licensing by their local Insurance Supervisor who will check the ultimate beneficiaries and Board members; • The list of captives in each jurisdiction is available providing full transparency; • The biggest captive jurisdictions worldwide have all implemented the automatic exchange of information in tax matters; • Captives are included in the list of consolidated companies in the owner's Annual Report and fully consolidated; • Captives are subject to external audit, quarterly or annual reporting to their Supervisory Authority, and 'on-site' inspections by the Supervisor.

"*opportunities surrounding inbound and outbound investment that potentially create competitive distortions between groups operating internationally and those operating in the domestic market*" (Action 4 §3)	They do not create **any unfair competition** between domestic and multinational corporations	• Captives are widely utilized by all types of corporations, multinational or domestic alike, as well as not-for-profit and public organisations; • Risk transfer arrangements are absolutely not similar to interest expenses from pure financing arrangements, since they involve payment of future claims as they occur in exchange for a set premium amount (profits can only be evaluated against long-term risk materialization and/or catastrophic risk exposures).
"*the over-capitalisation of low-tax rate group companies; the excessive-leveraging of high tax rate group companies; and contractual allocations of risk to low-tax jurisdictions in structures and transactions that would be unlikely to occur between unrelated parties*" (Action 11 §82-83)	They are **not set up to shift profits** from one country to another one	• Captives are writing international programs, providing coverage to numerous group entities worldwide; • Captives are widely utilized by all types of corporations, including public and not-for-profit organisations; • Captives underwrite lines of business where not only the parent company has an interest (e.g. liability business or employee benefits); • Under captive pricing strategies, many operate at long-term break-even or at a margin comparable to the insurance industry; • The main business reason behind the selection of an appropriate captive jurisdiction is the recognised capacity of the local Insurance Supervisor to regulate captives in an effective but proportionate way.
	They are **contributing to consumer protection** and improved products	• Captives led to new insurance products on the market over time, which ultimately is beneficial to consumers (e.g. extended coverages for professional liabilities and product liabilities for financial institutions, construction, or pharmaceutical products/services); • Captives play a role in the improvement of the risk profile of corporations, leading to less incidents/injuries and/or lower impact of risk (e.g. workers' compensation or employee benefits programs); • Captives give the ability to corporations to integrate insurance products in their purchasing and commercial strategy (e.g. extended warranties on manufactured products, more competitive motor insurances, payment protection insurances, weather/cancellation insurances)

In essence, captives enable organizations to be more cost-effective and fully accountable for their risk management and risk financing needs, in a regulated environment. Captives provide capital to accept risk and pay claims in return for payment of premium in that same fully regulated and transparent environment. This is a result that should be encouraged, not discouraged. Captives' principal purpose is not profit shifting between a high-tax jurisdiction and a low-tax jurisdiction. The use of captives by public and not-for-profit organizations, the group-wide international aspect of captive programs, and the existence of many on-shore captives, are all elements demonstrating the genuine non-tax purposes of captives.

Moreover, in the application of substance requirements, proper consideration needs to be given to the limited amount of policy and claims activities that are expected in a captive, and to the multiple expertise needed (underwriting, accounting, reporting, legal, actuarial, etc.), which therefore would make it non-economical for captives to hire their own permanent employees rather than procuring qualified resources from local insurance managers on an outsourcing basis.

Introduction

In its BEPS Action Plan dated October 2015 ("BEPS Action Plan"), the OECD makes couple of references to captives as being a potential source of BEPS, either explicitly or implicitly, more particularly in Action 3 on CFC rules (pp.43/45), Action 4 on interests' deductions (pp.15/27/76), Action 8-10 on transfer pricing (p.40), and Action 11 on measurement (pp.209/226). It is also envisaged that captives could be specifically excluded from the rules applicable to regulated financial institutions (Action 3 p.45 and Action 4 p.76).

In the Anti-Tax Avoidance EU Directive 2016/0011 initially published on January 28th 2016, later modified, and approved by ECOFIN on June 17th ("ATA Directive"), captives seem to have been also excluded from the definition of 'financial undertaking' in Article 2 as the text makes reference only to points (1) and (4) of Article 13 of the Solvency II Directive (2009/138/EC), while the Solvency II Directive also applies in the same way to captives that are defined under points (2) and (5) of that same Article 13. More precisely, in the Solvency II Directive, it is explicitly stated that "*references in this Directive to insurance or reinsurance undertakings should include captive insurance and captive reinsurance undertakings, except where specific provision is made for those undertakings*".

The risk management community believes this approach to captives in the context of BEPS is leading to inappropriate implementation of the OECD recommendations or the ATA Directive and would like to provide more information on what captive insurance or reinsurance companies really are to ensure adequate application of the OECD principles.

We fully understand and support the OECD objectives to counter "*tax planning strategies that result in a disconnect between the geographic assignment of taxable profits and the location of the underlying real economic activities that generate these profits*" (Action 11 §56 p.42), but that is also clearly not the reason why approximately 7,000 captive insurance or reinsurance companies currently in operation globally were created.

In a nutshell, "*captives*" are genuine insurance or reinsurance companies, fully regulated as such in their jurisdiction by the relevant Insurance Supervisory Authority, owned by a non-insurance group (i.e. a corporate or a banking group), and writing primarily risks from its parent group or from parties that are related to its parent group (e.g. employees, customers, suppliers, etc.). Please refer to the appendix for the definition of captive insurance and reinsurance companies as per the Solvency II Directive and the International Association of Insurance Supervisors (IAIS), as well as for some background information and statistics relevant to the captive industry worldwide.

In the following sections, we will outline the economic rationale of captive insurance companies, highlighting the relevance for their owners, and the governance and transparency requirements they are subject to.

Captive and BEPS Objectives

We understand that BEPS Action Plan's key objectives are to capture following situations:

- "*arrangements that achieve no or low taxation by shifting profits away from the jurisdictions where the activities creating those profits take place or by exploiting gaps in the interaction of domestic tax rules*" (Action 11 §56 p.42).

- "*tax planning strategies that result in a disconnect between the geographic assignment of taxable profits and the location of the underlying real economic activities that generate these profits*" (Action 11 §56 p.42).

- "*transfers of profits that are not in response to changes in the location of real economic factors, labour and capital*" (Action 11 §68 p.44).

- "*tax shifting due to BEPS, not real economic responses to tax rate differences that reflect the impact of current-law provisions adopted by legislators, including incentives to expand business operations in their country*" (Action 11 §69 p.45).

- "*the over-capitalisation of low-tax rate group companies; the excessive-leveraging of high tax rate group companies; and contractual allocations of risk to low-tax jurisdictions in structures and transactions that would be unlikely to occur between unrelated parties*" (Action 11 §82-83 p.115-118).

- "*domestic incentives designed to encourage artificial schemes without economic substance*" (Action 11 §83 p.119).

- "*opportunities surrounding inbound and outbound investment that potentially create competitive distortions between groups operating internationally and those operating in the domestic market*" (Action 4 §3 p.15).

- "*preferential regimes that are potentially harmful due to lack of transparency*" (Article 5 §20-21 p.14-18).

We fully support these objectives and will demonstrate in the following sections that, by nature, captive insurance or reinsurance companies:

1. are a **genuine risk management tool** for the group companies that own them;

2. are **not artificial structures**, even more so as they are fully regulated entities subject to similar rules as open market insurance or reinsurance companies ;

3. are **fully transparent structures**, part of the consolidation perimeter of their parent, and subject to detailed reporting on a regular basis to their Insurance Supervisor ;

4. do not create **any unfair competition** as they are set up by smaller or larger groups, domestic or multinational alike ;

5. are **not set up to shift profits** from one specific country to another one since they write global programs from a multitude of jurisdictions in the group, they collect (re)insurance premiums and pay back claims to those same jurisdictions, operating at margins similar to the insurance industry;

6. are **contributing to consumer protection** by enabling companies to better control their operating costs, by enabling companies or their related parties to benefit from better risk protection/coverage, and sometimes by providing consumers themselves with improved insurance products

1. Genuine risk management tools

As acknowledged by the International Association of Insurance Supervisors (IAIS) in Chapter 4.6 of its Application Paper from 2015, captives form an integral part of the "enterprise risk management" framework of corporations, as follows:

- Companies protect their risk via cross border global insurance structures (international programs) and captives are the state-of-the-art risk financing model providing a professional "total cost of risk" picture for all corporations engaged in production, distribution and provision of services within numerous different countries. Total cost of risk is a common measure used by corporations to decide on risk management and risk financing strategies. It combines the costs generated by risks that the corporation decides to retain on its balance sheet (both from an incurred loss and a capital-at-risk perspective), and the costs generated by risk transfer decisions (including insurance premiums and related transaction fees).

- The results from Aon's Global Risk Management Survey (GRMS) based on responses from 1,500 risk decision makers from 28 industry sectors indicates that 78% of respondents have a captive for one or more of the following reasons:

  - strategic risk management tool,
  - cost efficiencies,
  - reduction of insurance premiums,
  - risk finance expense optimisation, and
  - improved control over insurance programs.

Other reasons include access to reinsurance market, insurance cash flows optimisation, or ability to establish claims reserves against expected ultimate cost of claims over multiple underwriting years.

- Captives help corporations to develop a higher level of risk awareness by the insured entities. It fosters more intensive/visible and reactive local risk management, lower vulnerability and ultimately lower cost of production and services for the end consumers.

- Captives are the only entities within a non-insurance group which can consolidate operational risk exposures from all group entities by issuing (re)insurance policies, thereby facilitating risk data consolidation, improving risk control, reducing risk-related costs, enhancing capital-at-risk efficiency, and reducing risk transfer costs by avoiding sub-optimal deductible levels and duplication of coverages locally.

- Captives provide their owner with a higher level of transparency across the whole risk management value chain in areas such as commissions, fees, and administration costs, notably for claims handling and processing. This is for instance one of the key drivers behind the growing implication of captives in international employee benefits programs. Rather than a totally decentralised purchasing of employee benefits coverage in each country with resulting administration costs, friction costs, and coverage inconsistencies, the captive's implication in the program is a driver of international consolidation of information and exposures, consistency of coverage, control over costs, and ultimately reduced cost for the group and improved coverage for its employees.

- Although captives most often underwrite insurance covers that insured entities would have bought anyhow on the commercial insurance market in the absence of a captive (Property, General Liability, Marine, etc.), captives are also the only tool available to corporations to manage otherwise insurable but uninsured risk exposures in a formalized and regulated way. Captives can indeed insure more efficiently those risks which are insurable by nature but that the commercial insurance market has no appetite for because they might consider that costs of administration and claims handling are too high to be profitable enough (i.e. the area of high frequency/low severity losses), or alternatively because they are emerging/uncertain risk exposures that fall outside of the traditional underwriting risk appetite of most commercial insurers. According to Aon's GRMS, active examples of this include cyber exposures where 23% of respondents intend to underwrite the risk in the next 5 years, employment practices exposures (19%), credit exposures (15%), or warranties (8%). Another practical example of this are certain mandatory insurance coverages requested by regulators but that the traditional insurance market is not ready to provide (or at very expensive and restricted conditions), leaving no other choice to companies but to involve their captive (e.g. primary product liability insurance for pharmaceutical companies, professional liability insurance for accounting firms, etc.).

- Captives allow corporations to reinsure risk directly to the commercial reinsurance market (which is not possible for an insured entity without a captive involvement) and thereby can access the higher levels of capacity they need to protect their risks, at sometimes lower costs. This is vital for corporations which have very large risk exposures and for which the traditional commercial insurance market cannot provide enough capacity to match the desired level of protection.

- Organizations retain and utilize their captive even when commercial insurance market are in a 'soft' pricing market as is currently, because of all the non-pricing benefits such as better risk control/transparency, claims management, access to the reinsurance markets, and strong "ownership" of loss prevention efforts. It is then easy to expand the captive program and the group retention of risk in case the insurance market goes through a new market cycle and becomes 'hard' again on pricing and conditions.

- The next best alternative for corporations would either be to increase costs by purchasing more risk transfer on the commercial insurance market (if available), or to increase vulnerability of operating units and reduce risk control by increasing deductibles locally, thereby keeping more risk in the balance sheet of the operating entities in a non-regulated environment and with less transparency over cost of risk (and therefore less possibility to drive loss prevention programs).

The above demonstrates the important role that captives play in the risk management framework of corporations and proves, should there be a need, that the economic rationale of captives is not principally tax-driven.

Such intimacy with the parent's risk management framework also has consequences in terms of governance and substance as acknowledged by IAIS in Chapter 4.6 of its Application Paper : "*It is not necessary for a captive to duplicate work that has already been carried out at a group level. The Board of the captive should focus on risks that are specific to the captive. Risk tolerance limits for a captive will, to a large extent, be guided by the willingness of the parent company to provide capital and by the risks that are offered to the captive ; a captive does not generally seek out risk but rather waits until it is offered a risk by its parent (…). The simplicity of a captive's operational and reporting structure means that it can readily respond to changes in its risk profile* *and it is likely to be a part of a wider group feedback loop since one rational for operating a captive is to enable better reporting on insured risks and claims.*"

In conclusion, captives enable organizations to be flexible and fully accountable for their risk management and risk financing needs, in a regulated environment. This is a result that should be encouraged, not discouraged.

2. Non artificial structures

As acknowledged by the Solvency II Directive and by the IAIS, captives form an integral part of the global insurance/reinsurance market and need to be considered as such :

- Captives do perform genuine insurance or reinsurance activities by underwriting risks against capital. They are therefore fully regulated entities in the same way as "open-market" insurance and reinsurance companies are regulated entities. All risk-based governance, risk management, internal control, and capitalisation requirements prone by Solvency II in EEA, or by the Insurance Core Principles (ICPs) of IAIS in other key jurisdictions, do apply to captives in the same way as they apply to commercial insurance and reinsurance companies, only subject to the proportionality principle based on nature, scale, and complexity of the captive operations, and considering the fact that captives pose reduced risk to external stakeholders or to the financial stability of the insurance market.

- Captives operate in exactly the same way as traditional insurance or reinsurance companies in that they accept risk and pay claims in return for payment of premium. They may retain all or part of the risk themselves and reinsure in the commercial reinsurance market to protect their exposure. Aon's Captive Benchmarking Survey (Aon's CBS) performed in March 2016 among 1,000 captive owners indicates that around 40% of captives do in purchase reinsurance (or so-called retrocession) from the commercial reinsurance market.

- Insurers and reinsurers in the market fully support the captive business models by the provision of fronting facilities because they are able to carve out "undesired" risks and facilitate/enable the insurance placement on the traditional commercial insurance market. According to Aon's CBS, around 25% of captives do benefit from fronting services. Most common insurers providing such services include Ace, AIG, Allianz, AXA, FM Global, RSA, XL, or Zurich.

- Another standard characteristic of captives is arm's-length pricing based on the actual market price as defined by the fronting commercial insurer, or by market quotations obtained when developing the captive's underwriting strategy, or based on pricing models established by consulting actuaries.

- In terms of proportionality, Insurance Supervisors across the globe do recognise that captives have few transactions, limited number of policies, low complexity, and thus they do not conduct activity every day. This explains that the captive business model is built around proportionate supervision, low operating costs and the fact that hiring a full time employee in each and every captive would simply be non-economical for captive owners. Moreover, multiple expertise are needed to manage day-to-day operations of a captive (underwriting, accounting, reporting, legal, actuarial, etc.). To answer this business need, day-to-day management is outsourced to a professional insurance manager, located in the captive's jurisdiction, whose role is to execute the captive Board's decisions, to ensure local compliance, and to report to the local Insurance Supervisory Authority.

- Such outsourcing to professional insurance managers is encouraged by the Insurance Supervisors as explained in Chapter 4.1 of the IAIS paper : "*the captive's owners may not be familiar with the operational and prudential requirements of an insurer. Supervisors should therefore satisfy themselves that the captive will be managed by experienced professionals. (…) To meet this requirement, many captives use the services of insurance managers, which should have the necessary insurance knowledge, skills and resources. In the case of a captive that does not employ the services of an insurance manager, supervisors should require the board members and senior management of the captive to demonstrate that they have the required skills and experience to effectively carry out their roles, including appropriate underwriting and accounting skills.*" Decision making however always remains with the captive's Board of Directors (or Committees where applicable), as well as the accountability for proper oversight over the insurance manager or any other outsourced service providers.

- This is combined with the requirement to have a legal representative and/or licensed manager located in the jurisdiction in which the captive is licensed, role that is fulfilled by the same professional insurance managers who have to demonstrate the necessary insurance knowledge, skills and resources, before they can be appointed.

- Moreover, because captives are an integral part of their owner's risk management strategy, there are preparatory activities that take place by the owner when considering options for the structuring of insurance programs. If the owner believes a captive would add value to the group, or to the insured entities of the group, to have a share of the risk transfer transaction underwritten by the captive, this is then propose to the captive's Underwriting Committee, or the captive's Board in the absence of Committees, with supporting risk information. The captive's Committee/Board will then assess the opportunity from an underwriting perspective to ensure requested coverage and limits are within the captive's risk appetite and license scope, to ensure the pricing is appropriate, and to ensure it has sufficient capital base to write the risk. In this decision making process the captive could seek the support from insurance professionals that are part of the insurance manager's servicing team, from consulting actuaries, from experts, from brokers, etc.

- Other service providers used by captives to support their activities include auditors, lawyers, third party loss adjusters, etc. The availability of such a network of professionals experienced with the captive business model, and insurance managers in particular, together with the recognised capacity of the local Insurance Supervisor to regulate captives in an effective but proportionate way, are the key business reasons behind the selection of an appropriate jurisdiction for establishing a captive.

As mentioned, captives provide capital to accept risk and pay claims in return for payment of premium in a fully regulated environment.

Captive's Boards decide to take on or decline risks, they track the performance, they make decisions on how to respond to risk occurrences, they decide to outsource day-to-day operations to a professional service provider for cost efficiency, they define the duties of that provider, they select and appoint that provider, they track the provider's performance over time, and they ultimately can decide to terminate the contract with that provider and move to another provider.

By those decision-making activities at Board/Committee level, the captive effectively provides functions, risk and capital to implement the risk transfer transaction that generates the value creation.

Captive insurance companies are also the only entity in a non-insurance group which can consolidate operational risks from other entities by providing insurance covers, and thereby improve risk control and costs for the group it belongs to.

Moreover, because of the limited number of policies to issue, the low complexity, and the low frequency of transactions, all the decisions described above can easily remain within the Board or within Underwriting Committees without having to hire numerous staff. In fact, it would be virtually impossible for a captive on its own to attract as part time employee someone with all the required skills in underwriting, accounting, finance, reporting, legal, actuarial, etc. Hence the professional insurance managers model.

3. Fully transparent structures

Captives are fully transparent entities, as follows:

- Captives are incorporated as Limited Companies or Cell Companies, subject to licensing by their local Insurance Supervisor who will check the business plan, the shareholders and ultimate beneficiaries, the intended capital structure, the Board members, and key persons or services providers. This process is fully transparent in each jurisdiction as detailed in Chapter 4.1 of the IAIS paper.

- Shareholders, Board Members, and all key persons involved in the captive operations are subject to fit and proper requirements from the local Insurance Supervisor and have to be filed for prior approval.

- Captives, as legal entities, are fully registered with the Registry of Commerce (or equivalent) in each jurisdiction, articles of association are published, and in many jurisdictions annual financial statements are also published. This information is publicly available.

- The Insurance Supervisor in each jurisdiction maintains a full list of licensed captives in the jurisdiction and these lists are accessible on the regulator's web site therefore ensuring full transparency.

- The biggest captive jurisdictions worldwide have all implemented the automatic exchange of information in tax matters, including Bermuda, Cayman Islands, Guernsey, Germany, Ireland, Isle of Man, Luxembourg, Netherlands, Sweden, etc.

- Captives that are fully owned by a single ultimate parent company are listed explicitly within the list of consolidated companies in the Group's Annual Report, and are fully consolidated in the parent group's consolidated accounts (some being rather consolidated using the equity method for accounting reasons).

- Captives, as regulated entities, are audited each year by professional external auditors. At least annually (if not quarterly), captives have to provide a full regulatory reporting to their Supervisory Authority with full details on financial statements, underwriting and claims, investments, governance, risk profile, etc. In a Solvency II context, they are also subject to an Actuarial opinion to be delivered by an actuarial firm or an actuary approved by the Supervisory Authority. Finally, the Supervisor performs so called 'on-site' inspections for each captive on a regular basis as well.

In conclusion, captives are subject to strong reporting governance based on compliance with regulatory requirements and full transparency towards their local Supervisory Authorities. Shareholders, Board Members, beneficiaries, etc. are all scrutinised by the local Insurance Supervisor prior to approval.

4. Not creating unfair competition

Captives do not generate any unfair competition between corporations, as follows:

- Captives are widely utilized by large multinational corporations but also by medium sized businesses and not-for-profit organisations, including public entities. Based on Aon's CBS, about 20% of captive owners are corporations with consolidated revenues of less than USD 1 billion, about 47% of captive owners are public entities, and about 12% of captive owners are not-for-profit organisations. For example, a significant majority of non-profit hospitals in the U.S. utilize captives to cover their medical malpractice insurance requirements rather than relying on the volatile commercial insurance market that has a history of wild pricing and availability swings. Obviously, the use of captives by these not-for-profit and government owned organizations demonstrate the genuine non-tax purposes of captives.

- Moreover the use of captives by all corporations, multinational or domestic likewise, demonstrates they do not contribute to unfair competition driven by tax planning strategies that only multinational companies would have access to. For example, according to Aon's CBS, 94% of the risk exposures written by on-shore US parented captives are domestic US risks.

- Captive insurance arrangements are also absolutely not similar to interest expenses from pure financing arrangements which could create competitive distortions between multinationals and domestic market as targeted by Action 4 of the OECD. They are genuine risk transfer arrangements with payment of future claims as they occur in exchange of a set premium amount. Similar to any insurance company, profits can only be evaluated against long-term risk materialization and/or catastrophic risk exposures, and in no case should premiums simply be considered as profits or remuneration on a pure financing arrangement.

Consequently, captive insurance or reinsurance companies do not fall within the scope of "*opportunities surrounding inbound and outbound investment that potentially create competitive distortions between groups operating internationally and those operating in the domestic market*" as targeted by Action 4.

5. Not set up to shift profits between two countries

Captives are not setup in order to simply strip the taxable base of their owner's country of residence:

- Apart from the US domestic on-shore captives example mentioned above, a high proportion of captives write international insurance or reinsurance programs, providing coverage to multiple group entities worldwide, and therefore collecting premiums from a multitude of countries irrespective of their local tax rates, and irrespective of the captive jurisdiction. This is particularly true for EU parented captives who, according to Aon's CBS, write European-wide risk exposures at 63%, US risk exposures at 11%, and truly global insurance or reinsurance programs at 22%.

- Captives are also widely utilized by all types of corporations, including public and not-for-profit organisations. As mentioned above, based on Aon's CBS, about 47% of captive owners are public entities, and about 12% of captive owners are not-for-profit organisations.

- Moreover, as acknowledged by IAIS in Chapter 2 of its Application Paper, not all captives underwrite only classes of business such as property damage or business interruption for which only the parent company has an interest in the policy. Other captives write liability business or employee benefit risks where there may be third parties or employees with an indirect interest in the proceeds of the policy, despite the fact that the obligation to the third party rests with the captive owner. In other cases, captives write business for connected parties such as other companies in the same industry or for commercial customers or suppliers of the owner.

- Captive arrangements are genuine risk transfer transactions with payment of future claims as they occur in exchange of a set premium amount. As mentioned earlier, profits can only be evaluated against long-term risk materialization and/or catastrophic risk exposures, and in no case should premiums simply be considered as profits until the ultimate cost of claims is known. Claims reporting and development can take anything between a couple of months and more than a decade depending on the underlying risk. Liability risks or disability exposures are typical examples of so called "long tail" risk exposures.
- Under captive pricing strategies, many operate at long-term underwriting break-even or low cost-plus margins. According to Aon's CBS, captives operated in 2014 at a margin of 12.97%, while, according to the New York University Stern School of Business, the Property & Casualty insurance industry operated in the same year in the US at 14.60% margin, and in Western Europe at 14.75% margin.
- Like any insurance contract, captive insurance transactions are subject to insurance premium taxes (IPT) in the source countries. Moreover, if insurance premiums paid are deductible by the insured entities in their home country, any claims payment back to the insured entity is fully taxable as well in that country. In case of net underwriting profit at the captive level, this is subject to corporate income tax, therefore taxes are duly paid to all the appropriate jurisdictions where captive insurance companies do business.
- There are currently around 68 jurisdictions in the world that have enacted favourable legislation and environment for captives, and around 30 states within the US. When deciding on the best jurisdiction for establishing their captive, captive owners consider business reasons such as favourable legal and regulatory environment, experience of the local supervisory authorities with the captive business model to ensure proportionate treatment and reduced bureaucracy, availability of experienced service providers, skilled workforce, and the ability to underwrite the envisaged risk exposures according to international insurance laws (e.g. only an EEA jurisdiction for the captive grants the "passport" to write EU-wide risk exposures, US Employee Benefits risks can only be underwritten by a US-based captive, Swiss risk exposures can only be written out of Switzerland itself or Liechtenstein, etc.). In all the well-established captive jurisdictions the network of skilled professionals familiar with the captive business model will be very well developed and captive owners will easily find professional insurance managers with local operations, local audit firms, lawyers, actuaries, asset managers, etc. who are all capable of offering relevant services to these captives. Such

market infrastructure and familiarity with the captive business model cannot be found elsewhere.

- Aon's CBS which indicates that 25% of respondents have selected their captive jurisdiction based on the domicile's experience with the captive business model, 17% for the legal and regulatory infrastructure, and 16% for the flexibility and efficiency of the regulator.

- An increasing number of jurisdictions enact favourable legislation and regulatory environment for captives so that corporations can set up their captives in their home country/state rather than having to search for an appropriate captive jurisdiction outside their home base. The US states in particular have seen a massive development of on-shore captives in recent years proving that the dynamics behind setting up a captive are not tax-driven. Nowadays, more than half of the US parented captives are established on-shore US. But that is also true for Canadian parented captives who, according to Aon's CBS, are 73% on-shore Canada, or Swedish parented captives who are now 54% on-shore Sweden as well while they used to be mostly outside Sweden 10 years ago before Sweden changed its regulatory environment for captives. Worth mentioning Australia, Germany and Netherlands as well, who do have a few on-shore captives since they have demonstrated some attractiveness for the captive business model, but only when these are sizeable enough, due to limited proportionality by the Insurance Supervisor still. On the other hand, captive owners from countries with no favourable captive environment such as Belgium, Finland, France, Italy, Japan, Spain, or the UK have established their captives in more favourable jurisdictions.

In conclusion, captives' principal purpose is not profit shifting between a high-tax jurisdiction and a low-tax jurisdiction. The use of captives by public and not-for-profit organizations, the group-wide international aspect of captive programs, the payment of claims back to insured entities as risk materialises, the payment of insurance premium taxes in the source countries, and the existence of many on-shore captives, are all elements demonstrating the genuine non-tax purposes of captives. Moreover, regulatory framework and professional network are real business reasons that make a jurisdiction more or less attractive for captives.

6. Contributing to consumer protection

Captives do contribute to corporations' safety and continuity, as well as to controlled production costs and extended warranties for end consumers, as follows:

- As captives allow their owners/parent company to insure risks for which, to a certain extent, the traditional commercial insurance market has no appetite, this has created an opportunity for the development of improved risk management practices and better control over those emerging risks. In turn, new insurance products were created on the market over time once the "commercial" insurers realized that a risk they previously formerly declined to cover was now in fact managed by their client and became quantifiable and controllable to appropriate levels for them to underwrite. The ability for corporations to access better insurance products and wider coverages is in the end of benefit for consumers. Examples of this include extended coverages for professional liabilities and product liabilities which ensure indemnities are paid to customers in case of errors, omissions, or product defects (e.g. Financial Institutions, Construction, Pharmaceutical).

- By facilitating control over risks, captives also play a role in the improvement of the risk profile of corporations and in the risk prevention programs, leading to less incidents and/or lower impact in case of occurrence. Examples of this include Workers' Compensation or Employee Benefits programs whereby the control over consolidated claims data that the captive enables can in turn be a trigger for prevention programs within the corporation so that injuries and absences are progressively reduced.

- By reducing the cost of risk for its parent, and thereby the total operating costs, captives do contribute, to some extent, to cost control efforts that most corporations undertake to manage their production costs and therefore maintain the price to customer on the market at competitive levels.

- When captives are writing business for connected parties such as other stakeholders in the same industry, or for commercial customers or suppliers of the owner, they give the ability to the captive owner to integrate insurance products in its purchasing and commercial strategy. This typically translates into expanded product/service offering providing the end customer with either more security around the product/service he is buying, lower costs of personal insurances, or more options for managing his own budget. Examples of this include extended warranties on manufactured products provided by manufacturers or retailers, competitive motor insurance offerings by car manufacturers or leasing companies, credit life protection on mortgage loans provided by financial institutions, payment protection insurances on leasing and other types of payment commitments, weather and cancellation insurances on holidays booking provided by hotels or travel agencies, etc.

In conclusion, by being an active player in the captive owners' risk financing strategy and in the global insurance and reinsurance market, captives do contribute to achieve lower vulnerability, lower costs of production, and expanded services for the end consumers.

Conclusions

Captives are subject to exactly the same regulatory environment in terms of governance, risk, and capital, as other insurance and reinsurance companies, only subject to the application of the proportionality principle.

Furthermore, we have illustrated in this document how captives do improve the economic position of their group through improved risk management and transparency, cost of risk minimisation, and centralised risk capital. As such their income is not disconnected from their underlying value creation.

We have also demonstrated how captive are not artificial arrangements implemented for BEPS purposes and that they are fully transparent, notably towards their regulatory authorities in each jurisdiction. Consistently with our views, captive arrangements were also not listed as potential aggressive tax planning strategies and indicators in the recently published Final Report commissioned by the European Commission on “Structures of Aggressive Tax Planning and Indicators” (Working Paper N°61-2015). Based on OECD’s BEPS reports and other tax literature, this report identifies seven models representing all major empirically proven channels for profit shifting: hybrid financing structures, hybrid entity structures, two-tiered IP structures,, one-tiered IP structures, offshore loan structures, interest-free-loan structures, and patent-box structures. None of these structures relate to or involve captive arrangements.

We do acknowledge, as per OECD Action 4, that it is also not intended that entities operating in the banking and insurance sectors, or regulated banking or insurance entities within non-financial groups, should be exempted from the best practice approach contained in the BEPS Action Plan. However further work needs to be conducted to identify best practice rules to deal with the potential base erosion and profit shifting risks posed by the particular features of captive insurance and reinsurance companies.

These rules should ensure that the captive arrangement has a genuine economic rationale, that it is not artificial, that it is transparent, that arms’ length principle is respected, and that the captive is effectively providing functions, risk and capital to generate the value creation. But captive arrangements should however not systematically be considered suspicious of BEPS in the “catch-all” approach that seems to be developing today by local tax authorities against captives.

In particular, the application of substance requirements should duly take into account the fact that captives have a limited amount of policies and claims to manage, and that they require multiple expertise (underwriting, accounting, reporting, legal, actuarial, etc.), which would make it non-economical for captives to hire their own permanent employees rather than procuring qualified resources from local insurance managers on an outsourcing basis.

Appendix

Captive definition

Both the Solvency II EU Directive from 2009 (2009/138/EC) and the Application Paper of the International Association of Insurance Supervisors (IAIS) from 2015, consider captive insurance and reinsurance companies to be clearly in-scope of their insurance/reinsurance regulations and provide a specific definition of 'captives' as follows:

- In Article 13 of the Solvency II Directive, captive insurance undertaking is defined as "*an insurance undertaking, owned either by a financial undertaking other than an insurance or reinsurance undertaking (…) or by a non-financial undertaking, the purpose of which is to provide insurance cover exclusively for the risks of the undertaking or undertakings to which it belongs or of an undertaking or undertakings of the group of which it is a member*";

- In Chapter 2 of its Application Paper on the Regulation and Supervision of Captive Insurers dated November 2015, the IAIS defines a captive insurer as "*an insurance or reinsurance entity created and owned, directly or indirectly, by one or more industrial, commercial or financial entities, the purpose of which is to provide insurance or reinsurance cover for risks of the entity or entities to which it belongs, or for entities connected to those entities and only a small part if any of its risk exposure is related to providing insurance or reinsurance to other parties*".

While the Solvency II Directive definition is more restrictive in terms of scope of underwriting, we believe the IAIS definition that was agreed on a more global scale by Insurance Supervisors better reflects the captive market realities and its practices.

They form an integral part of the risk management framework of their parent, as well as an integral part of the worldwide insurance and reinsurance market.

Captive industry overview

Captive insurance arrangements have become widespread in the risk management / risk transfer industry over the last 40 years or so, and they form an integral part of the global insurance and reinsurance market for commercial risks:

- There are close to 7,000 captives in existence worldwide, many of which have been underwriting the insurance risks of their parent and affiliate companies for more than 20 years, considering the fact that the captive industry started its expansion in the 1960's in the US, and in the 1980's in Europe.

- Captive owners come from all geographies and all industry sectors, as well as all revenue sizes. They include private and public companies, listed and non-listed companies, multinational and domestic companies, limited companies and non-for-profit organisations.

- A significant number of these captive insurance companies are essentially reinsurance companies for the insurance risks of their parent or affiliate companies and utilize the fronting services of a commercial insurance company that is licensed in the jurisdiction where the risk is insured.

- Captive industry is estimated to grow at 4% per year in the last 10 years. This growth is mainly driven in the recent years by a 30% growth in on-shore USA captive jurisdictions for the period 2012-2014, while European jurisdictions have declined by 15%. Asia-Pacific is currently under-represented in the captive industry with only 2% of the global captives but substantial growth is expected from that region in the years to come.

- The recent market developments and especially the introduction of cellular companies (i.e. Protected Cell Companies, Incorporated Cell Companies, and Segregated Cell Companies) resulted in lower logistical burden and financial cost for the companies wishing to possess their own captive. As a result, captives have become more and more accessible and attractive for mid-size companies which are expected to continue to drive the numbers of captives up in the years to come.

- The results from a Global Risk Management Survey performed by Aon in May 2015 (Aon's GRMS) among 1,500 risk decision makers from 28 industry sectors indicates that about 18% of respondents had an active captive, and that about 6% of respondents were planning to create a new or additional captive by 2017 year end.

- There are 68 jurisdictions with captives' expertise in the world. 40% of worldwide captives are operating out of the US (there are about 30 captive-friendly states in the US nowadays) and another 45% are operating in the Americas. The remainder of worldwide captives are spread across European jurisdictions (13%) and Asian jurisdictions (2%). These jurisdictions all have enacted pro-captives legislation and environment. Unlike many jurisdictions, they offer availability of experienced service providers, skilled workforce, and a local supervisory authority experienced with the captive business model that then ensures proportionate treatment and reduced bureaucracy.

- The vast majority of those captives are simple operations by nature, size, and complexity. Aon's Captive Benchmarking Survey (Aon's CBS) performed in March 2015 among 1,000 captive owners indicates that 70% of captives are writing 1 or 2 lines of coverage, which would translate in a handful of policies to manage and varying degrees of claims activity depending on the exposure that is underwritten.

- Aon's GRMS further shows that the most frequently underwritten lines of coverage within a captive are traditional commercial insurance lines that any corporation would insure such as Property (59% of respondents), General/Third Party Liability (45%), Workers Compensation (28%), Product Liability (27%), Errors & Omissions Liability (26%), or Auto Liability (25%). Emerging lines of coverage that are expected to grow most in the coming years include Employee Benefits, Cyber Liability, Trade Credit, Extended Warranty, and customer/contractor insurance programs.

- To ensure that all the operational and prudential requirements of captive insurance or reinsurance companies are met at any time, and in a cost effective way, the captives are managed by professional insurance managers, who are experienced professionals to whom the Board of Directors of the captive delegates the day-to-day operations in application of the Board's decisions.

- Captives also make use of a number of other service providers in their jurisdiction such as external auditors, actuarial firms, investment managers, specialist claims administrators, law firms, etc. The availability of such infrastructure with experienced service providers in the captive's jurisdiction is key to the successful development of the captive.

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