

# ***PS LA 2007/8 - Treatment of non-resident captive insurance arrangements***

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⚠ This document has changed over time. This version was published on *11 November 2010*



# Practice Statement Law Administration

**PS LA 2007/8**

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**FOI status: may be released**

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*This practice statement is issued under the authority of the Commissioner and must be read in conjunction with Law Administration Practice Statement PS LA 1998/1. It must be followed by ATO staff unless doing so creates unintended consequences or is considered incorrect. Where this occurs ATO staff must follow their business line's escalation process.*

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**SUBJECT: Treatment of non-resident captive insurance arrangements**

**PURPOSE: To provide ATO staff with direction on the treatment of non-resident captive insurance arrangements, including determining commercial purpose and manner of the arrangement**

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## STATEMENT

1. Legislative references in this practice statement are to the *Income Tax Assessment Act 1936* (ITAA 1936) or the *Income Tax Assessment Act 1997* (ITAA 1997).
2. Where officers encounter arrangements involving deductions for premiums paid to captive insurance entities, they must determine the taxation consequences of the insurance premiums paid, including whether they are allowable deductions. The following facts and circumstances of the particular arrangement should be considered:
  - Whether the captive insurance entity:
    - (a) is exposed to incur a significant loss under the arrangement
    - (b) assumes a significant insurance risk
    - (c) is authorised and registered to conduct an insurance business in the local jurisdiction
    - (d) actually has the financial capacity to pay any insurance claim that it is required to make in relation to the risk insured, and
    - (e) has entered into an arrangement which may be a sham designed to mask the true economic and legal implications that flow from the arrangement.

These factors will help to determine the commercial legitimacy of the insurance arrangement and whether an actual insurance business is being conducted.

The following factors may impact on the taxation consequences of insurance premiums paid to a captive insurance entity, which in turn will determine the deductibility of the premiums in Australia, as well as any Australian taxation consequences to the captive insurance entity itself:

- Whether the amount of deductions claimed under section 8-1 of the ITAA 1997 is properly referable and proportionate to the actual insurance coverage provided, or whether the expense may be excessive.
- Whether the deduction claimed for the insurance coverage is acceptable for transfer pricing purposes under Division 13 of Part III of the ITAA 1936, or whether the profitability of the captive insurance entity is a profit expected to accrue to the captive insurance entity for the purposes of Article 9/ Associated Enterprises Article (generally) of our treaties – note the various Taxation Rulings on the application of Division 13 and/or Article 9/ Associated Enterprises Articles.
- Where the captive insurance entity is properly a resident of Australia under the definition of resident in subsection 6(1) of the ITAA 1936 and a member of a consolidated group, the income tax consequences of the insurance arrangement between the captive insurance entity and another member of the same consolidated group are ignored as the head company is taken to be both insured and insurer.<sup>1</sup> In determining residency, consideration should be given to the place of central management and control of the entity – note Taxation Ruling TR 2004/15.
- Where the captive insurance entity is not a resident of Australia, whether the income it receives is properly Australian-sourced income for the purposes of subsection 6-5(3) of the ITAA 1997.
- Whether premiums paid or payable to a non-resident captive insurance entity should be included in its Australian assessable income under Division 15 of Part III of the ITAA 1936.
- Where the captive insurance entity is not a resident of Australia, whether it may be a controlled foreign company (CFC) under Part X of the ITAA 1936. Where there are resident taxpayers investing into the captive insurance entity, officers should consider if any may be an attributable taxpayer under that Part in respect of the captive insurance entities income, including both tainted sales income (under section 447 of ITAA 1936), and tainted services income (under section 448 of ITAA 1936).<sup>2</sup>
- Whether Part IVA of the ITAA 1936 may apply on the basis that the captive insurance arrangement was entered into for the dominant purpose of obtaining a tax benefit – note Law Administration Practice Statement PS LA 2005/24 Application of General Anti-Avoidance Rules.

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<sup>1</sup> See Taxation Ruling TR 2004/11 Income tax: consolidation: the meaning and application of the single entity rule in Part 3-90 of the *Income Tax Assessment Act 1997*.

<sup>2</sup> Note both provisions are possibly modified by subsection 446(4) of ITAA 1936.

## **EXPLANATION**

3. A captive insurance entity is an insurance entity where the parent company is not primarily engaged in the business of insurance. It is usually formed to insure the risks of its parent and affiliates, but it can also be used to insure third party risks. A captive insurance entity can retain the risks or it can pass on the whole or a part of the risks. A captive insurance entity would normally operate in a similar way to other general insurance or reinsurance companies.
4. For the purposes of this practice statement a captive insurance arrangement is a contract of insurance with an offshore captive insurance entity:
  - that is either directly or indirectly controlled (for example consider the control rules under Part X of the ITAA 1936) by an Australian resident parent entity (including a consolidated group), and
  - whose insurance business is principally that of providing indemnity for insurance risks of the resident parent and/or other entities in an associated group.
5. Under a captive insurance arrangement, an Australian resident entity pays premiums to the captive insurance entity so as to be indemnified for loss or damage arising upon the happening of a specified insurable event.

### **Commerciality of risks covered and premiums charged**

6. Officers should evaluate the evidence, in particular the contract of insurance, to determine whether the captive insurance arrangement results in a legitimate commercial coverage of risks (refer to Taxation Ruling TR 96/2), as opposed to an arrangement for the purposes of taxation consequences only. The commercial legitimacy of the insurance arrangement could impact on these taxation consequences. Indicators which will assist in demonstrating the commerciality legitimacy include:
  - the risk insured under the arrangement is capable of being insured in accordance with insurance law and commercial practices
  - there has been a transfer of significant insurance risk from the insured to the captive insurance entity, with indemnity provided
  - the insurance indemnity must exist and must not be compromised (for example via a loan back arrangement or via a refund of premiums)
  - premiums paid for risk cover are not excessive when compared to what premiums would be paid to an arm's length insurance company for the risk covered, and
  - the captive insurance entity has the financial capacity available to meet the liabilities required to be paid.

### Commercial purpose

7. Officers should evaluate the evidence to determine whether the captive insurance entity was established for commercial purposes (for example see the decision in *WD & HO Wills (Australia) Pty Ltd v. FC of T* 96 ATC 4223; (1996) 32 ATR 168; (1996) 65 FCR 298). Indicators which might demonstrate this include:
  - there has been expert advice obtained to support the commercial reasons for establishment of the captive insurance entity, and
  - there has been a report by a qualified actuary to support that the level of premiums charged are reasonable for the nature of the risk to be carried by the captive insurance entity.

### Commercial manner of operation

8. Officers should evaluate the available evidence to determine whether the captive insurance entity operates in a commercial manner. Indicators which might demonstrate this include:
  - there is a documented investment strategy for the investments to be made by the captive insurance entity
  - the types of investment made by the captive insurance entity are typical of those made by arm's length insurers (for example, investments are made by the captive insurer outside the group rather than back into the group)
  - there have been business and profit plans and projections made for the captive insurance entity on an ongoing basis
  - there are regular reports by a qualified actuary that satisfy all local licensing requirements to support the adequacy of the insurance reserves to meet the ongoing obligations of the captive insurance entity, and
  - claims are made or settled in the way they would be under an arm's length general insurance arrangement.

### Transfer of significant insurance risk

9. It is necessary that the arrangement indemnifies the insured and that there is a transfer of significant insurance risk.

### Taxation issues

10. The following issues are relevant to determining the taxation effect of a captive insurance arrangement:
  - **Deductibility of premiums** – If officers conclude that the premiums claimed are excessive given the actual insurance coverage provided in respect of insurable risks actually transferred, then the amount of deductions allowable under section 8-1 of the ITAA 1997 are to be fully considered. Officers should refer to *Fletcher v. FCT* (1991) 103 ALR 97; 91 ATC 4950.

- **Transfer pricing** – If officers conclude that the premiums paid by the insured are not acceptable for transfer pricing purposes, then a determination for the purposes of Division 13 of Part III of the ITAA 1936 must be made accordingly. Alternatively if profits expected to be accrued to the captive insurance entity have not been so accrued, then such profits may be taxed to the captive insurance entity under Article 9/ Associated Enterprises Article (generally) of the treaties.<sup>3</sup>
- **Residence** – If officers conclude that the captive insurance entity is properly a resident of Australia under the definition of resident in subsection 6(1) of the ITAA 1936, and is also a member of a consolidated group, the single entity rule contained in section 701-1 of the ITAA 1997 will have the effect that the income tax consequences of intra-group insurance arrangements will be ignored. Officers should refer in particular to Taxation Ruling TR 2004/15 in determining residency questions.
- **Australian taxation of non-resident captive insurance entities** – Where the captive insurance entity is not a resident of Australia, and the income it receives in respect of the captive insurance arrangement is properly Australian-sourced income, the assessment of non-resident insurers is governed by Division 15 of Part III of the ITAA 1936 (sections 142 and 143). Officers should consider whether the Division applies to include premiums paid or payable to the captive insurance entity in its Australian assessable income. However, the Division only applies to genuine insurance arrangements. Accordingly, where a captive arrangement is not accepted as a genuine insurance arrangement for taxation purposes then Division 15 will have no application.
- **Double Taxation Agreements** – Officers should consider the implications of any double tax agreements between Australia and the jurisdiction where the captive insurance entity is located.
- **Controlled foreign company regime** – Where the captive insurance entity is not a resident of Australia, officers should consider if it may be a CFC under Part X of the ITAA 1936. Where there are resident taxpayers investing into the captive insurance entity, officers should consider if any may be an attributable taxpayer under that Part in respect of the captive insurance entities income, including both tainted sales income (under section 447 of ITAA 1936) and tainted services income (under section 448 of ITAA 1936).<sup>4</sup>
- **Sham** – If officers conclude that a purported captive insurance arrangement is a sham and of no legal effect, then no deduction will be allowable for any expenses incurred under that purported arrangement.
- **Part IVA of the ITAA 1936** – Officers should consider whether Part IVA of the ITAA 1936 may apply on the basis that the captive insurance arrangement was entered into for the dominant purpose of obtaining a tax benefit – see PS LA 2005/24.

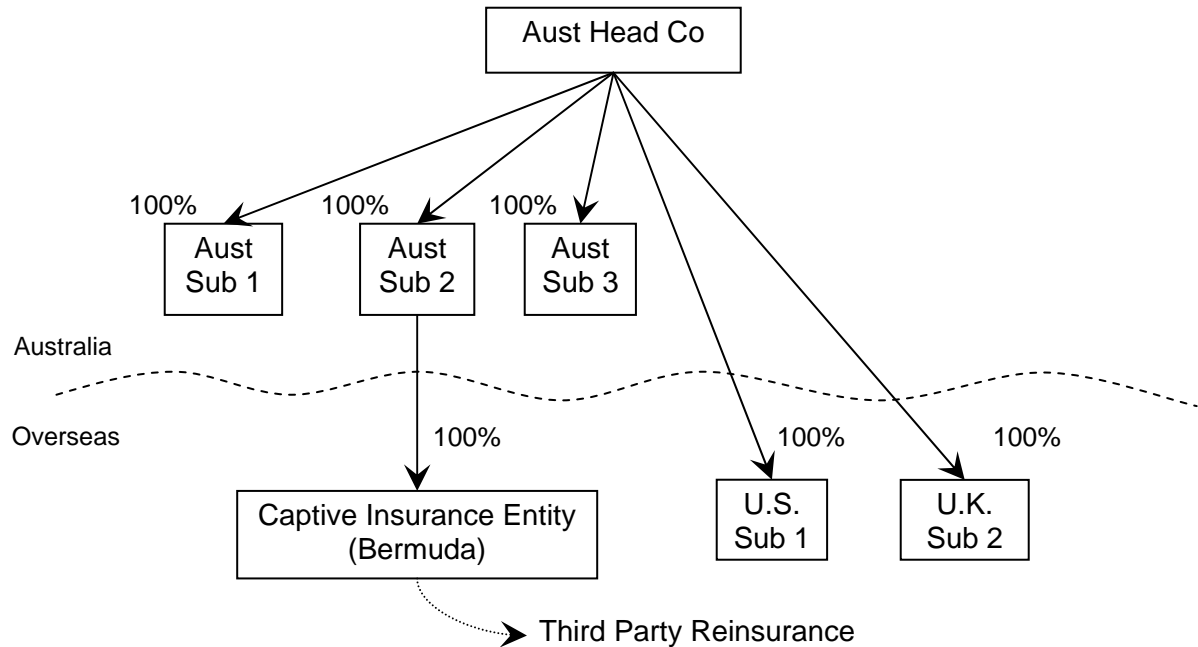
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<sup>3</sup> Note: Officers must comply with the various Taxation Rulings on the application of Division 13 and/or Article 9/Associated Enterprises Article and the existing business process required for such determinations to be made.

<sup>4</sup> Note both provisions are possibly modified by subsection 446(4) of ITAA 1936.

## Examples

### 11. Example 1

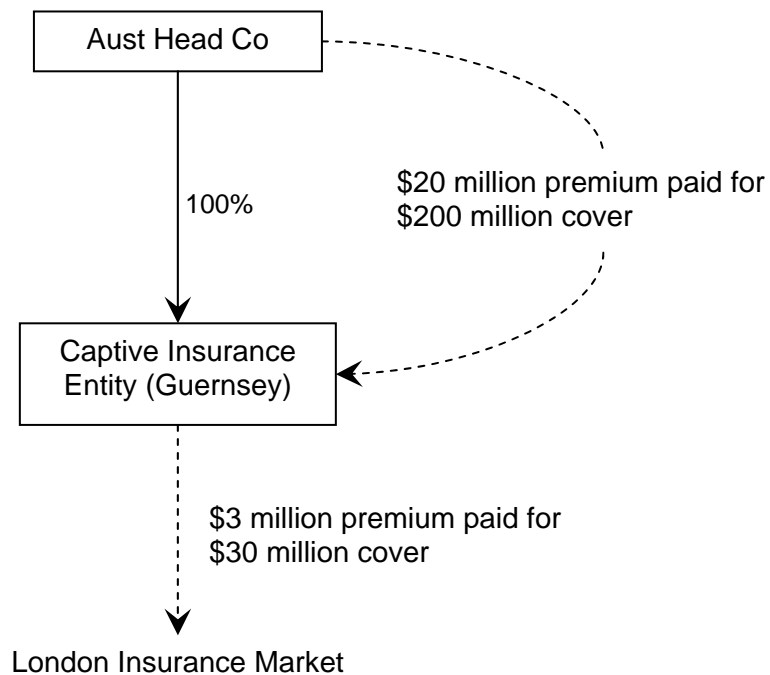


- Australian Group sets up a captive insurance entity in Bermuda.
- The captive insurance entity provides insurance cover to all members of the group for all types of insurance needs.
- Each group member pays a commercial and arm's length rate of insurance premium for the cover provided, with a commercial rate of excess agreed.
- The captive insurance entity is able to reinsure its own insurance risk with an independent insurance provider, enabling the captive to payout on any insurance claims.

This scenario would be acceptable as an insurance arrangement for the following reasons:

1. There is a genuine transfer of insurance risk to the captive insurance entity (and reinsurer) from each member of the group.
2. Premiums are commercial and arm's length relative to the insurance provided.
3. The captive insurance entity can and does pay out on any insurance claims made by members of the group.
4. The arrangement is commercial in nature due to the number of parties involved and the manner of the operation and insurance provided.

12. **Example 2**



- Australian Parent sets up a captive insurance entity in Guernsey.
- Parent takes out insurance contract with the captive insurance entity for \$200 million insurance cover and pays \$20 million premium to the captive insurance entity for that coverage.
- The captive insurance entity retains \$17 million premium and \$170 million insurance risk.
- Captive insurance entity takes out a reinsurance contract for \$30 million and pays \$3 million premium.
- The captive insurance entity has recourse to the reinsurance contract for the first \$30 million plus the \$17 million retained premium (plus investment earnings) to cover insurance claims made by the parent.
- The captive insurance entity does not have any other financial capacity to cover the \$200 million policy and needs to meet the balance of any insurance claim from other sources.
- Actuaries have determined that there is a reasonable likelihood of the captive insurance entity receiving claims of not greater than \$30 million (which the Captive would fund by recourse to the reinsurance contract with the London Insurance Market).
- The reinsurance premium of \$3 million paid to the London Insurance Market is considered to be an arm's length price for the \$30 million cover.

This scenario would not be accepted as a captive insurance arrangement for the following reasons:

1. Actuaries have determined that insurance claims by the Australian Parent in excess of \$30 million would only arise from the occurrence of 1 in 1000 year events. The probability of the captive insurance entity needing to fund claims from sources other than by recourse to the reinsurance contract is therefore remote.
2. As the arm's length price for \$30 million cover is \$3 million, and the probability of claims becoming payable in excess of \$30 million is lower than for claims becoming payable under \$30 million, a reasonable person might conclude that an arm's length premium for the \$170 million cover retained by the captive insurance entity would be less than the \$17 million premium retained.
3. The captive insurance entity does not have the financial capacity to satisfy the \$200 million coverage provided.
4. The transfer pricing provisions and possible implications of this arrangement under Part IVA of the ITAA 1936 would need to be given full consideration.

**Amendment history**

<b>Date of amendment</b>	<b>Part</b>	<b>Comment</b>
3 July 2013	Contact details	Updated.
21 November 2011	Contact details	Updated.
11 November 2010	Contact details & general style update	Updated & changed reference to Tax Office to ATO.
12 August 2008	Contact details	Updated.

Subject references	captive insurance; transfer pricing; commercial purpose
Legislative references	ITAA 1936 6(1) ITAA 1936 Pt III Div 13 ITAA 1936 Pt III Div 15 ITAA 1936 142 ITAA 1936 143 ITAA 1936 Pt IVA ITAA 1936 Pt X ITAA 1936 446(4) ITAA 1936 447 ITAA 1936 448 ITAA 1997 6-5(3) ITAA 1997 8-1 ITAA 1997 Pt 3-90 ITAA 1997 701-1
Related public rulings	TR 96/2; TR 2004/11; TR 2004/15
Related practice statements	PS LA 1998/1; PS LA 2005/24
Case references	Fletcher v. FCT (1991) 103 ALR 97; 91 ATC 4950 WD & HO Wills (Australia) Pty Ltd v. FC of T 96 ATC 4223; (1996) 32 ATR 168; (1996) 65 FCR 298
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