Structuring multinational insurance programmes in Europe

Intragroup risk financing – considering the issues

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Focus on Europe

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1. Overview

“ What do I need to consider when my insurer in Europe pays out on a claim relating to a loss in another country where it is an unlicensed carrier? ”

Because every insurance policy is first and foremost a ‘promise to pay’ in the event that the unexpected happens, this is, perhaps, the single most important question for European risk managers to consider before structuring a multinational insurance programme. Most insurers are licensed in their place of incorporation and may insure risks world-wide. However, when it comes to paying claims, only a few countries expressly permit an unlicensed insurer to pay claims directly in respect of risks located there. In addition, the majority of countries often impose significant burdens on local brokers and clients before a local risk can even be underwritten by an unlicensed carrier, including the remittance of local premium taxes and prior approvals.

In research conducted by ACE recently with over 600 European companies, local policy compliance and claims settlements emerged as the two top compliance concerns for respondents structuring multinational insurance programmes, cited as a major worry by 48% and 40% of companies respectively. In the Benelux region, concern was among the highest of any of the six markets surveyed, with 56% saying that local policy compliance was a major concern and 44% highlighting claims settlements as an issue. However, these are not just important issues for the risk manager or director of insurance to consider. Insurers, clients and brokers are all subject to regulatory and legal oversight and will want their insurance products to be materially compliant in every jurisdiction in which they operate. Regardless of whether the insured has purchased a master policy for the parent company, or a series of local policies for its subsidiaries and affiliates, none of the parties involved will want to assume unnecessary regulatory and tax risks.

The fact is that multinational programmes do raise significant compliance issues, particularly in respect of income tax. And, because multinational insurance programmes are a combination of risk transfer and risk financing, anticipating and preparing for the performance challenges of cross-border insurance requires forethought, consultation and expertise. A team of finance, tax and legal specialists may well be required so that the right solutions can be customised for each multinational enterprise. In this report, we review some of the key issues, focusing on the complex issue of intragroup transfers of insurance proceeds between related parties. Following a description of one typical scenario, we consider the questions that multinational insurance clients, brokers and insurers should ask when structuring a complex cross-border insurance programme. We then discuss the importance of insurance documentation, including corporate, intra-group transactions. The report ends with a consideration of factors that risk managers and their financial colleagues should consider with respect to intra-group transactions when designing and implementing a multinational insurance programme.

2. Multinational case study and questions

For illustrative purposes, we have set out a case study and questions to consider, featuring a European multinational company.

Case study

- Assume that a multinational group specialising in natural gas exploration and transportation, headquartered in Western Europe, has subsidiaries, affiliates and joint ventures throughout the world.
- Its most important subsidiary is in a jurisdiction in Eastern Europe that does not permit unlicensed insurance to insure local risks.
- This subsidiary and the pipeline in the subsidiary's jurisdiction are insured under a local policy with a limit of €5 million. A natural catastrophe punctures the pipeline and transportation of natural gas is suspended until the pipeline is repaired and is certified before the suspension is lifted and it is back on line. The total damage from this catastrophe is approximately €10 million.
- The local policy pays a €5 million claim.

Four questions to consider

Question 1: If the local policy pays the claim of €5 million, who may most likely pay the additional €5 million in order to repair the pipeline and bring it back into operation so that it can be certified locally to transport natural gas?

The local policy claim payment of €5 million is not enough to repair the pipeline and bring it back on line in time to meet the deadline for natural gas production for the calendar quarter. However, failing to bring the pipeline on line in a timely basis could affect the parent company economically – and potentially impact its reputation and its commitment to the business and region. In addition, performance contracts for clients serviced may be breached and the parent company may ultimately be responsible for any damages incurred following the breach. If the enterprise is a public company, with shares traded on an exchange, shareholders may also decide to sue the parent company should the share value suffer because of the parent's inaction. For all these reasons, the party most likely to pay the additional €5 million to repair the pipeline, unless there are excess cash or liquid assets locally, is the parent company.

According to Michel van der Breggen, the Financial Services Transfer Pricing Partner at the Amsterdam office of PwC, "In the absence of any documented pre-arrangement between the parent company and the subsidiary and assuming the parent company steps in to pay the €5 million, a number of financial, tax and regulatory questions arise. The central economic questions, which drive the financial, tax and regulatory concerns, relate to how the payment is treated and what compensation should the parent company have received prior to it remitting the additional €5 million."

Question 2: If the parent company assumes the €5 million obligation and pays the amount to its subsidiary, with whom should the parent consult in order to address financial, tax and regulatory concerns when it makes this payment?

To answer this question, according to Jenny Coletta, Ernst & Young (EY) Executive Director and European Insurance Transfer Pricing lead, and James Smith Executive Director in EY's Financial Services Insurance Regulatory practice, both of whom are based in London, a number of issues are likely to require further consideration:

- What are the current financial obligations of the parent to its subsidiary and vice versa?
- Are there existing arrangements between the two companies that require or would make it beneficial for the parent to pay this obligation, or, indeed, would restrict such a payment?
- Are these existing arrangements documented from a commercial, tax and regulatory perspective?
- Does the subsidiary have excess capital so that the parent does not, in fact, have to assume this obligation? If so, has the parent supported the subsidiary in respect of the excess capital? And if so, what are the regulatory and tax implications of this support?
- If the parent has to assume this obligation, what is the best way, from a financial, tax (taking into account, among other things, indirect taxes and withholding taxes) and compliance point of view, of delivering the obligation to the subsidiary? For example, is it preferable for the parent to provide parental support in the form of reimbursement or capital support in relation to the subsidiary's losses and/or for the parent to have purchased insurance for losses in the subsidiary's jurisdiction?
- Is there existing documentation, for example, transfer pricing documentation, in place between the related parties (the parent and subsidiary in this case) to support the payment assuming the parent bears the financial obligation of the excess loss?
- If there is no existing documentation, what documents are required in order to demonstrate that this transaction between related parties is transparent, efficient and compliant for regulatory and tax purposes in the jurisdictions of the parent and the subsidiary?
- Are there any domestic tax regulations or tax treaties between the parent's jurisdiction and the subsidiary's jurisdiction to minimise any tax or fiscal surcharges?
- What does local regulation define as insurance? – might, for example, an explicit commitment to contingent parental support in the form of either reimbursement or capital support fall foul of prohibitions on non-admitted insurance, particularly if the parent charges the subsidiaries for providing that commitment?
- Going forward, the group should consider the effect the proposed arrangement may have on future group pricing – for example, how any change in rate, reinstatement costs etc. may impact the wider group and how these costs should be allocated between the parent and subsidiaries.

Should the parent company assume this obligation, it will therefore most likely need to assemble a team of financial and tax experts (both internal and external), to consider each of these issues and deliver the best result for the parent company as well as its subsidiary.

"Without any pre-arrangement between the parent and the subsidiary and critically, documentation to support the pre-arrangement, from a tax perspective", states Job Hoefhagel a Senior Manager specialising in international tax aspects within the Financial Services Sector of PwC, "there is a greater likelihood that the relevant taxing authorities, in their favour, could use hindsight to recharacterise any payment from the parent to the subsidiary. Hence, assembling the team of financial and tax experts before the inception of the transaction proactively manages this risk."

Question 3: **May the parent purchase insurance for its €5 million obligation in its own jurisdiction?**

Depending on the jurisdiction where the parent is located, if the parent chooses to, it may insure its obligations by purchasing a Master Differences in Condition (DIC) and Differences In Limit (DIL) Policy with an insurer authorised or permitted to insure such risks in the parent's jurisdiction. In many jurisdictions in Western Europe, a parent company may insure its interests in its shareholdings, legal or contractual obligations in its subsidiaries, affiliates or joint ventures. This concept, known as insurable interest, is recognised under insurance laws in the member states of the European Union and almost all other countries in Western Europe. Alternatively, in some jurisdictions, a parent may purchase financial loss insurance to insure its world-wide exposures.

Therefore, a parent company insuring its insurable interests in its subsidiaries, affiliates and joint ventures in its jurisdictions supplemented by local policies with adequate and appropriate limits purchased by its affiliates should significantly reduce the risks to clients, intermediaries and insurers associated with non-compliant, unlicensed insurance.

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Insurable interest and how it may be calculated

- Under Dutch law, as well as under Belgian, English, French and German law, an insured must have a sufficient interest in the subject matter of the insurance to support a valid and enforceable policy.
- Thus, in general, a policyholder must gain a benefit from the preservation of the subject matter of the insurance or suffer a disadvantage should it be lost.
- It is generally accepted that a parent company has an insurable interest in its financial or economic interests in its subsidiaries, affiliates and joint ventures.
- Because the parent policy (or master policy) indemnifies the parent for losses to its insurable interest in its subsidiaries, affiliates and joint ventures caused by property damage and liabilities suffered by such entities, it is essential to clearly define the parent's economic interest and the mechanism by which its subsidiaries', affiliates' and joint ventures' property damage and liabilities will be determined.
- In general, the parent's ownership and economic interest in its subsidiaries, affiliates and joint ventures, as well as any legal or contractual obligations of the parent to procure insurance covering such entities' losses, may dictate how such losses may be calculated and indemnified.

Question 4: If the parent chooses to insure such amount in its jurisdiction for itself and the €5 million insurance claim is paid to the parent, what does the parent need to consider if it chooses to remit such amount to its subsidiary?

Developing a globally compliant insurance programme is not an easy task. However, naming the parent as the insured under the master policy and applying the principles of insurable interest forms the basis for providing consistent terms and insurance coverage to the parent and its worldwide interests.

The main challenges usually arise in navigating the often inconsistent laws of multiple jurisdictions that invariably govern cross-border insurance programmes. In particular, the concept of insurable interest can introduce complex inter-company allocation issues.

The parties to the multinational insurance programme must document the business purpose of the transaction as well as ascertain the appropriate payment by the affiliated entity to the parent for the insurance policy procured by the parent. In respect of claim payments received by the parent, if the parent chooses to remit such payment to the affiliated entity, documentation must also support such payment. According to Mohamed Serokh, a Financial Services Transfer Pricing Director at PwC based in Zurich, Switzerland, "in the case of a master policy covering multiple subsidiaries and a multitude of different types of risks, issues relating to the intra-group allocation of the costs and benefits of the parent's procurement of insurance to protect its global interests, can become a lot more complicated. Hence an analysis of the impact of premiums paid by the parent, any corresponding costs allocated to its affiliates, the claim received by the parent and any corresponding payments remitted to its subsidiary needs to be considered for documentation purposes to ensure regulatory and tax compliance."

"Intra-group payments between related parties, which include payments between a parent and its affiliated entities," adds EY's Jenny Coletta, "typically raise the critical issue of transfer pricing, an internationally recognised tax concept that is key to the proper recognition of local taxable revenue and deductions involving inter-company transactions." Jenny continues,

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"the basic principle behind any inter-company transaction (including the allocation of insurance premiums, claims payments and reinstatements) is that for tax purposes an appropriate and reasonable price must be established and supported with appropriate documentation showing that the exchange or transfer of services is priced at arm's length. In addition, a wider tax analysis should also consider indirect taxes such as insurance premium taxes."

It therefore seems fair to say that although transfer pricing considerations do not directly affect the insurable interest of the parent in the subsidiary (and thus the ability of the parent to obtain master policy coverage in its home jurisdiction), it does directly affect the parent's treatment of the payment it receives on an insurable interest claim.

Before a parent company chooses to insure its interests in its subsidiaries affiliates and joint ventures in its jurisdiction, it should consider the following:

- May a claim be paid in the jurisdiction where the loss occurred? Some jurisdictions prohibit an unlicensed insurer from insuring local risks and directly paying claims. Many jurisdictions do not permit an unlicensed carrier to insure local risks unless proper regulatory and tax protocols have been followed by the local subsidiary.

- If the intent is to purchase the parent policy for the parent's insurable interests and the parent chooses to allocate some or all of the cost to its subsidiaries, affiliates and joint ventures, what is the appropriate analysis that needs to be conducted and documented? How will the parent's costs be allocated amongst its subsidiaries? Can such costs be allocated according to measurable risks or is a rudimentary allocation key, e.g. local turnover, acceptable? This is not only important for income taxes but in many countries, it is also relevant for determining in which jurisdiction premium taxes are due.

It therefore seems fair to say that although transfer pricing considerations do not directly affect the insurable interest of the parent in the subsidiary (and thus the ability of the parent to obtain master policy coverage in its home jurisdiction), it does directly affect the parent's treatment of the payment it receives on an insurable interest claim.

- How can the parent ensure that it is not itself seen as conducting insurance business, in breach of local regulatory prohibitions?

- If the parent policy results in a bulk discount of premiums (relative to a situation under which different subsidiaries were to purchase their own policy), how should any saving be treated for financial, tax and regulatory purposes? Should the parent be allocated all of the saving in its role as central procurer? Or should the saving be allocated to the subsidiaries?

- If a Master DIC-DIL Policy insures the parent in the parent's jurisdiction and a claim is paid to the parent for its insurable interests in a subsidiary, the parent should consult with its team of financial and tax experts internally, as well as external advisors on the most appropriate and compliant way to handle the claim amount.

- Is there existing documentation in place between the parent and the subsidiary to facilitate this payment?

- What consideration should be given to intra-group arrangements such as transfer pricing arrangements to support the payment from the parent to the subsidiary in a transparent and compliant manner?

3. Transfer pricing implications for a multinational insurance programme

The principles of transfer pricing require that a corporate parent be adequately compensated by its affiliated entities for the service it renders, such as that performed in procuring a master insurance policy. Similarly, if a covered claim is paid to the parent for a loss connected with its insurable interests in its affiliated entities, appropriate contractual arrangements should be negotiated and agreed between the parties. This should enable the parent to pay an amount equal to the covered claim to the relevant affiliated entity without unintended, adverse tax consequences. In addition to exploring the applicability of transfer pricing and other tax issues to the specific facts in a multinational programme, diligence should also be applied to assure that local insurance regulations are appropriately considered, again so that tax issues and regulatory issues do not conflict and lead to unintended consequences.

For example, a parent company domiciled in the Netherlands may purchase a policy covering its insurable interests in a foreign subsidiary. If the foreign subsidiary suffers a loss (e.g. the foreign subsidiary's factory is destroyed or a director or officer of the foreign subsidiary is sued and is not otherwise covered by a local policy), the parent will be indemnified under its policy (the 'master policy') and may, in turn pay a similar amount to the foreign subsidiary for the loss. From an economic perspective (but not necessarily a regulatory perspective), the foreign subsidiary should incur the cost associated with the premium paid for the policy.

Appropriate transfer pricing documentation and arrangements should be negotiated and agreed in advance, which will allow for the reasonable allocation of the cost of the premium paid by the parent plus its procurement costs in relation to the insurance from which the foreign subsidiary would ultimately benefit. By entering into appropriate transfer pricing agreements, the purchaser of a master policy may be reasonably confident that a covered claim received under its insurance policy and paid by the purchaser to its foreign subsidiaries, affiliates or joint ventures, will receive the appropriate income tax treatment.

Transfer pricing principles and implications

Principle of arms-length

Many countries have provisions that allow local tax authorities to adjust the income, deductions, credits, or allowances of commonly controlled taxpayers to prevent evasion of taxes or to clearly reflect their income for tax purposes. For example, member countries of the Organisation for Economic Co-operation and Development ("OECD"), including most countries in the European Union and certain other countries like Russia, China and India, treat each enterprise within a multinational group as a separate entity, whose profit may be adjusted to reflect the arm's length income for tax purposes. Under the OECD guidelines, a transaction between or among related entities (such as between a parent and subsidiary or between joint ventures sharing a common corporate structure) meets the arms-length standard if the results of the transaction are consistent with the results that would have been realised if unaffiliated or independent third party entities had engaged in the same transaction.

Transfer pricing analysis

The OECD guidelines list several methods for determining the appropriate arms-length transfer price, even though there is no standard approach to determine an arms-length price. The first step of a transfer pricing analysis is to select a transfer pricing method that is appropriate to the particular facts and circumstances of each transaction. Because transfer pricing is not an exact science, it is prudent to consult with internal as well as external accounting, tax and financial specialists before making any determination.

Documentation

Documenting all aspects of the transaction is important to support the transfer pricing of the arrangement. A transfer pricing report generally contains an analysis supporting the conclusion that the transaction is within an arms-length range. In general, this report may serve multiple purposes, such as to protect against penalties, to satisfy legal requirements, and can be a useful tool in the event of an audit by a taxing authority.

Reasonable documentation of the costs allocated for a multinational insurance programme may include 1) a global inter-company policy in relation to the insurance arrangement; 2) a signed agreement for each or all inter-company arrangements; and 3) a report with the analysis supporting that the prices charged between affiliates are arms-length.

A global transfer pricing policy describes the company's approach to setting transfer prices, e.g. which risks are covered under local policy and which under the master policy, how the companies share costs (premiums and administrative costs of services) of the insurance programme, etc. Inter-company agreements reflecting a legitimate business purpose and signed by all parties are also important to demonstrate the arm's length nature of the transaction.

4. Conclusion

Compliance with multinational insurance laws is a critical consideration for any European-based multinational company. But this alone is insufficient to establish a robust and fully compliant multinational insurance programme. At the outset, companies entering into such programmes need to understand the income tax and premium tax consequences of any multinational arrangement. Moreover, although insurance regulatory compliance has historically fallen on the shoulders of the insurer and its broker, issues related to the transfer pricing of the insured group and its affiliates are the responsibility of the group purchasing the insurance as part of its tax compliance obligations.

It is generally accepted that a parent company has an insurable interest in its financial or economic interests in its subsidiaries, affiliates and joint ventures. Insuring the parent company under the master policy consistent with the insurance laws of the parent company's jurisdiction significantly reduces the risks to clients, brokers and insurers associated with non-compliant, unlicensed insurance. This multinational solution lends itself to widespread application in the major European domiciles in which large multinational groups are concentrated.

The concept of insurable interest can introduce complex inter-company allocation issues. A transaction is generally considered to meet the arms-length standard if the results are consistent with those that would have been realised if unaffiliated or independent third party entities had engaged in the same transaction. Acceptable documentation might include a global inter-company policy in relation to the insurance arrangement; a signed agreement for each or all inter-company arrangements; and a report supporting the analysis that the prices charged between affiliates are arms-length. The documentation and other arrangements should be negotiated and agreed in advance, particularly to avoid the significant risk that such transactions can be recharacterised by taxing authorities

When designing and implementing a multinational programme, clients, brokers and insurers should recognise the importance of an independent third party's documented assessment of the ultimate consideration charged for the multinational programme and the resulting allocations made to various related parties. Ultimately, by working with experienced accounting, tax and financial specialists to design a comprehensive global transfer pricing programme, with documentation and supporting contractual arrangements fitting the specific needs and goals of multinational enterprises, European risk managers should be able to deliver a measurably compliant international insurance programme that satisfies the collective objectives of the client, insurance broker and insurance carrier.

About the Author:

Based in New York, USA, **Suresh Krishnan** is General Counsel for the ACE Group's Multinational Client Group, where he has global legal oversight for matters connected with the company's multinational products and services. With more than 20 years of experience in the insurance industry, Mr. Krishnan most recently served as General Counsel of ACE USA and ACE Financial Solutions