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TAX POLICY ISSUES RELEVANT TO CAPTIVE INSURANCE COMPANIES IN ALBERTA

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TAX POLICY ISSUES RELEVANT TO CAPTIVE INSURANCE COMPANIES IN ALBERTA

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EXECUTIVE SUMMARY

Alberta now permits the creation of captive insurance companies. Captive insurance companies insure their shareholders' risks and sometimes those of their shareholders' customers. Captives are licensed insurance companies controlled by a single firm or by firms that are part of an industry association. While the cost savings captives can provide are beneficial, national or multilateral tax policies can impact the viability of captive insurance structures. This paper discusses the tax policy issues that may affect Alberta's captive insurance regime.

More than half of the world's approximately 7,000 captives are located in the United States; there are only an estimated 20 located in Canada. Most of the other captives are in Caribbean low-tax jurisdictions or tax havens. Alberta cannot compete with Caribbean tax rates and will therefore probably not be successful in attracting captive insurance business if its regulatory policy treats captives like regular insurers.

Working in Alberta's favour are recently enacted and proposed multilateral tax avoidance measures which will result in higher costs for creating and maintaining a captive in a tax haven jurisdiction. If the OECD's Pillar II proposals come to fruition, they also require all in-scope captives to pay a minimum 15 per cent tax rate regardless of residence.

This paper reviews the significant Canadian tax issues that affect captive insurance companies, including GST/HST, federal excise taxes, provincial premium taxes and income tax. It also breaks down the likelihood of attracting non-Canadian versus domestic captives, looking at possible regulatory and tax policy structures and their likelihood of success.

Alberta will probably not attract captive insurance business from non-Canadian multinational enterprises. However, the ability to insure or reinsure Canadian risks while avoiding negative tax consequences and achieving potential tax and tax compliance savings makes Alberta more attractive for captive insurance business from Canadian firms. While there is a possibility that other provinces or the federal government could retaliate if Alberta engages in aggressive inter-provincial tax competition, retaliation is unlikely unless Alberta materially reduces or eliminates provincial income taxes for captives.

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1. INTRODUCTION

Alberta recently enacted legislation that will permit the creation of captive insurance companies.[2] This legislation came into force on July 1, 2022.[3] Critical regulatory items, like capital requirements, financial reporting obligations, and insurable persons or risks, are the subject of a separate research paper on the captive insurance market published by the School of Public Policy.

Captive insurers are licensed insurance companies that are controlled by a single firm or by firms that are part of an industry association, which insure risks of their shareholders or, in some instances, the customers of their shareholders. There are various non-tax reasons for the creation of captive insurance companies that the author has canvassed elsewhere (Dolson 2020), including the reduction of insurance costs through self-insurance or direct access to the reinsurance market. Nevertheless, tax considerations can motivate the creation and location of captive insurance companies, meaning that national or multilateral tax policy choices will impact the viability of captive insurance structures and where captive insurers are created. This paper explores tax policy issues that could impact the success of the Alberta captive insurance regime.

2. REGULATORY POLICY VS. TAX POLICY

It is estimated that there are approximately 7,000 captives worldwide, not counting separate cells of protected cell insurance companies (National Association of Insurance Commissioners 2021). Of these 7,000 captives, slightly more than half are domiciled in the United States (Business Insurance 2021a); popular American domicile choices include Vermont, Utah and Delaware (Business Insurance 2021b). Most of the remaining captives are domiciled in Caribbean jurisdictions like Bermuda, the Cayman Islands or Barbados, while Luxembourg and Guernsey account for around half of all captives not located in the United States or the Caribbean. It is estimated that there are only 20 captive insurance companies organized in Canada.

The existence of many captive insurers in the United States — a relatively high-tax jurisdiction — suggests on its face that regulatory or other non-tax concerns may be significant factors in location decisions for corporate groups with captive insurers. This may be somewhat deceiving, however. The United States has special tax rules for insurance companies (especially life insurance companies) that may result in a lower effective federal income tax rate for a captive than would apply to the parent;[4] these rules allow for a different taxable income calculation than would be used for other corporations and could result in very little tax being payable if there are increases in the insurer's reserves. Furthermore, many U.S. states, including Vermont, Delaware and Utah, do not impose taxes other than premium taxes on insurance companies, regardless of the source of their income. Thus, using a captive may allow for the shifting of taxable income from higher tax states to a non-taxable entity.

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[2] *Captive Insurance Companies Act*, S.A. 2021, c. C-2.4.

[3] Ibid., Section 84, read together with Order-in-Council O.C. 194/2002 dated June 1, 2022.

[4] 26 USC §831 (life insurers) and §832 (property and casualty insurers).

That is not to say that regulatory policy does not matter; the author's experience is that business location decisions in all industries are based on commercial, regulatory and tax considerations. The clustering of captive insurers in, say, Bermuda or Vermont is a byproduct of favourable tax policy, the presence of experienced insurance administrators and other necessary infrastructure and favourable regulatory policy. Anecdotally, the author understands from discussions with insurance administrators that one of the reasons British Columbia's captive insurance regime is relatively unpopular is that regulators adopt an approach towards captives that resembles their approach to regular insurers.[5] Since Alberta will likely not be able to compete with Bermuda on tax rates and may have difficulty competing with Vermont on tax rates if larger reserve deductions are allowed for U.S. federal income tax purposes than for Canadian income tax purposes, Alberta will probably not attract many captive insurers if it adopts a regulatory position like the one in British Columbia.

3. AN OVERVIEW OF SIGNIFICANT CANADIAN TAX ISSUES FOR INSURANCE COMPANIES

To understand which tax policy opportunities may be available to Alberta in its efforts to attract captive insurers, it is essential to review the tax rules applicable to insurance companies. Because almost all captive insurers controlled by Canadian corporations are resident outside of Canada, the tax rules necessarily include Canada's foreign affiliate rules, which apply to all non-resident subsidiaries of a Canadian parent regardless of the subsidiary's business.

Equivalent tax regimes in foreign jurisdictions are outside the scope of this paper. Tax policy decision-makers should nevertheless bear in mind that most foreign jurisdictions have adopted tax regimes like the Canadian regimes described below. For example, the United States imposes excise taxes on premiums paid to foreign insurers or reinsurers in relation to domestic taxpayers or domestic risks.[6] The United States also has a controlled foreign corporation (CFC) regime that includes imputation rules for passive income (including income from insuring U.S. persons or risks),[7] as well as what is in effect a minimum tax of 13.125 per cent for active business income earned by CFCs.[8] Thus, Alberta may only be a suitable jurisdiction for the captive insurer of a U.S. multinational group if there are non-U.S. risks to insure and the effective tax rate is high enough to avoid minimum taxes.

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5 British Columbia's captive regime is governed by the *British Columbia Insurance (Captive Company) Act*, R.S.B.C. 1996, c. 227.

6 26 USC §4371.

7 Ibid., §951 (imputation), §953 (insurance income) and §954 (foreign personal holding company income).

8 Through the combined operation of 26 USC §951A and §250 and §960(d). Under current law, this minimum tax rate will increase to 16.406 per cent for tax years after 2025. There is a high-tax kick-out that applies where the foreign tax rate is at least 90 per cent of the 21 per cent U.S. federal corporate tax rate: 26 CFR §1.951A-2. This provision forms the U.S. global intangible low tax income (GILTI) regime, which is the subject of various current legislative proposals and relevant to the OECD's Pillar 2 initiative (discussed below) and therefore may change.

A. GST/HST ISSUES

The supply of an insurance policy by a captive insurer resident in Canada is an exempt supply of a financial service when made to a Canadian resident or when relating to Canadian risks,[9] and a zero-rated supply when made to a non-resident in respect of non-Canadian risks.[10] A captive insurer will therefore not be required to collect GST/HST when it issues an insurance policy or receives premium income, but will also not be entitled to input tax credits to the extent that it generates premiums from insuring Canadian risks.[11]

Potentially more significant are the GST/HST compliance obligations. A Canadian-resident captive insurer is a financial institution, a listed financial institution and a selected listed financial institution for GST purposes.[12] As a financial institution, the captive insurer is required to file an additional annual information return.[13] As a selected listed financial institution, the captive insurer will be required to use the special attribution method to compute net tax;[14] this will effectively force the captive insurer to calculate its net tax by apportioning taxable supplies received and input tax credits available between participating provinces and non-participating provinces in which the captive insurer operates.

B. FEDERAL EXCISE TAXES

Canadian resident persons or non-resident corporations carrying on business in Canada who pay premiums in respect of Canadian risks to an insurer not authorized to transact the insurance business in Canada must pay a 10 per cent premium tax.[15] This tax does not apply to certain types of insurance, including life insurance and sickness or accident insurance, and may not apply to a policy of any type if, in the Canada Revenue Agency's (CRA) opinion, the insurance is not available in Canada.[16]

The federal excise tax, coupled with Alberta's low corporate income tax rates, creates an incentive for a Canadian multinational group to locate its captive insurer in Alberta if the captive is insuring Canadian risks and adequate insurance is available through Canadian insurers. Leaving aside the income tax consequences of insuring Canadian risks through a non-Canadian captive, the federal excise tax means that the Canadian insured pay an additional 10 per cent of the gross premium as tax if the premium is paid to a non-Canadian captive. This can render many offshore captive insurance arrangements non-economical.

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9 See the definitions of "financial instrument" and "financial service" in subsection 123(1) of the *Excise Tax Act*, R.S.C. 1985, c. E-15 (the "**ETA**") and section 1, Part VII, Schedule V of the ETA.

10 Section 2, Part IX, Schedule VI of the ETA.

11 As input tax credits are only allowed under 169(1) to the extent GST/HST is paid in respect of supplies acquired in the course of commercial activities. The term "commercial activities" is defined in subsection 123(1) of the ETA as excluding a business making exempt supplies.

12 See the definition of "financial institution" in subsections 149(1) and 123(1) of the ETA, the definition of "listed financial institution" in subsection 123(1) of the ETA and the definition of "selected listed financial institution" in subsections 225.2(1) and 123(1) of the ETA.

13 Section 273.2 of the ETA.

14 Ibid., subsection 225.2(2).

15 Ibid., subsections 4(1) and (3).

16 Ibid., subsection 4(2).

C. PROVINCIAL PREMIUM TAXES

Provinces impose premium taxes on insurance companies that are licensed to transact business in the province. For example, Alberta imposes premium taxes equal to three per cent of gross premiums receivable for life insurance or accident and sickness insurance (excluding reinsurance) transacted in Alberta, or four per cent of gross premiums receivable for all other types of insurance transacted in Alberta (excluding reinsurance).[17] By comparison, Ontario imposes premium taxes equal to two per cent of gross premiums receivable for life insurance or accident and sickness insurance transacted in Ontario, 3.5 per cent of gross premiums receivable for property insurance transacted in Ontario or three per cent of gross premiums receivable for all other types of insurance transacted in Ontario (all excluding reinsurance).[18] Most or all provinces exempt reinsurance from premium taxes.

Provinces also impose premium taxes or regulatory charges on insurance policies issued by insurance companies not licensed to transact business in the province. For example, Alberta requires the purchaser of insurance to pay a regulatory charge equal to 10 per cent of the premiums paid to an unlicensed insurer.[19] While Ontario also imposes premium taxes on the purchasers of unlicensed insurance in Ontario,[20] the premium tax rate is the same as the rate payable by licensed insurers.[21]

To protect their premium tax base, provinces have also enacted unfair discrimination rules; some U.S. states have enacted similar laws. For example, if another jurisdiction imposes taxes or fees on an insurer having its principal offices in Ontario that are higher than the taxes or fees imposed on insurers organized under the laws of that jurisdiction, Ontario may impose a retaliatory premium tax on insurers from that jurisdiction that transact business in Ontario.[22]

Premium taxes are a potentially important tax policy lever since, all other things being equal, a corporate group would choose to locate a captive in a jurisdiction with lower premium taxes. However, the importance of this lever is diminished for Alberta because:

- Canadian provincial insurance premium taxes typically only apply to premiums receivable for business transacted in the province, as compared to the United States where insurance companies have traditionally been subject to premium taxes only in their home jurisdiction. As a result, Alberta premium taxes may only be relevant to the extent that the Alberta captive is insuring Alberta risks;[23]

- Alberta does not have the power to control how other jurisdictions impose premium taxes on premiums paid to an Alberta captive insurer in respect of business transacted in that other jurisdiction; and

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17 Subsections 87(1.1) and 88(1) of the *Alberta Corporate Tax Act*, R.S.A. 2000, c. A-15.
18 Subsections 74(1) and (4) of the *Corporations Tax Act*, R.S.O. 1990, c. C-40.
19 Paragraph 61(1)(b) of the *Insurance Act*, RSA 2000, c. I-3, as modified by section 2 of *Bill C-16: Insurance Amendment Act, 2022*, Legislature 30, Session 3.
20 Subsection 2(2.2) of the *Corporations Tax Act* (Ontario).
21 Ibid., subsection 74.3(2).
22 Subsection 74(9) of the *Corporations Tax Act* (Ontario).
23 See, for example, the definition of "business transacted in Alberta" in paragraph 86(1)(c) of the *Alberta Corporate Tax Act* or subsection 74(6) of the *Corporations Tax Act* (Ontario).

- Alberta's ability to incentivize captive insurers to locate in Alberta through favourable premium taxes for Alberta captive insurers versus other insurers, through subsidies to compensate Alberta captive insurers for premium taxes paid elsewhere, or through taxes and regulatory charges on premiums payable to non-Alberta insurers, risks other jurisdictions imposing retaliatory premium taxes on Alberta insurers transacting business outside Alberta.

Given the more limited scope of Alberta's premium taxes, premium taxes are unlikely to incentivize or disincentivize a corporate group to establish an Alberta-resident captive insurer. Even eliminating premium taxes entirely would probably not have a material impact on the competitiveness of Alberta as a residence jurisdiction for captives since most insured risks will be located outside of Alberta. In any case, the Canadian income tax regime disincentivizes insuring Canadian risk through non-Canadian captives far more than eliminating premium taxes could ever incentivize businesses to insure Alberta risks through Alberta captives.

D. INCOME TAX

There are three principal Canadian income tax concerns for captive insurance arrangements: (i) whether the payment to the captive insurer is deductible by the payer in computing its taxable income; (ii) whether any person resident in Canada is required to include an amount in respect of the premium in computing its income, as foreign accrual property income (FAPI) or otherwise; and (iii) the amount that may be deducted as policy reserves in determining the income inclusion for any Canadian person who is required to include amounts in income. All three of these concerns will be discussed in further detail below.

These income tax concerns are products of the federal *Income Tax Act*,[24] and thus are not within Alberta's control or legislative competence. Even if these items were within Alberta's control or legislative competence, Alberta likely would not wish to alter the operative legislative provisions since they are primarily intended to prevent Canadian taxpayers (including Alberta taxpayers) from shifting income outside of Canada. Nevertheless, an understanding of these concepts is critical in appreciating the limits on Alberta's ability to attract captive insurance business through tax policy.

i) Payments for Insurance

Insurance premiums are deductible in computing income from a source that is business or property,[25] but self-insurance, whether in the form of a reserve, a sinking fund or some other accounting mechanism, does not give rise to deductible amounts.[26] The Federal Court of Appeal has ruled that the distinction between insurance and self-insurance is that the former involves a legally enforceable transfer of risk from the insured to the insurer, without any guarantee or similar backstop of the insurer's obligations offered by the insured.[27]

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24 *Income Tax Act*, R.S.C. 1985, c. 1 (5th Supp.) (the "**ITA**"). All statutory references hereafter are references to the ITA unless otherwise noted.
25 Pursuant to subsection 9(1).
26 Paragraph 18(1)(e).
27 *Consolidated-Bathurst Limited v. R.*, 87 DTC 5001 (F.C.A.), at 5005-7, reversing in part 85 D.T.C. 5120 (Fed. T.D.).

Risk shifting ought not to be a significant impediment to the creation of a captive arrangement in a jurisdiction like Canada, where the focus is on the parties' legal relationships and legal constructions and not on the "economic substance" of those relationships.[28] There may be a trap for the unwary; for example, where a captive purports to insure a parent's risk but a third party (say, a reinsurer) requires the parent to guarantee the captive's obligations. Traps of this nature are easily avoided with proper professional advice.

ii) Imputation of Insurance or Reinsurance Income as FAPI

In tax-motivated captive insurance arrangements, the primary objective is for the captive's income from insurance or reinsurance income to be realized by a non-resident entity. If this non-resident entity is a controlled foreign affiliate of the Canadian parent, a related objective is to avoid the captive's insurance or reinsurance income being characterized as FAPI that will be included in the Canadian parent's income on an accrual basis regardless of whether it is repatriated. Ensuring that the captive is resident outside of Canada, and that the income of the captive is not FAPI, would allow for either a lengthy deferral of Canadian corporate income tax or a total exemption from Canadian corporate income tax.

a) Residence of Captive Insurance Entity

Corporations incorporated in Canada are deemed to be resident in Canada.[29] Corporations not incorporated in Canada are resident in the place where central management and control is exercised (which, without care and discipline, could be in Canada even if not intended),[30] unless a bilateral tax treaty applies to override or supplement this determination.[31]

Residence is critical for two reasons. First, if the captive is resident in Canada, then its income is subject to tax on a worldwide basis;[32] causing a captive's income to be subject to tax in Canada rather than in a low-tax or no-tax jurisdiction would defeat the purpose of many arrangements. Second, if the captive is a foreign affiliate or a controlled foreign affiliate of a Canadian corporation, is resident in a designated treaty country,[33] has its central management and control in that designated treaty country[34] and carries on an active business in a designated treaty country,[35] the insurance or reinsurance income

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28 See *Shell Canada Ltd. v. R.*, [1999] 3 S.C.R. 622 (S.C.C.) at paras. 39, 45–46, reversing 98 D.T.C. 6177 (F.C.A.), affirming 97 D.T.C. 395 (T.C.C.). For recent examples of the Canadian courts giving effect to these legal constructions as the framework for their commercial and tax outcomes (in various contexts), see *CAMECO Corporation v. R.*, 2020 D.T.C. 5059 (F.C.A.), affirming 2018 D.T.C. 1138 (T.C.C.), leave to appeal refused (2021) (S.C.C.); *Alta Energy Luxembourg S.A.R.L. v. R.*, 2021 SCC 49, affirming 2020 D.T.C. 5021 (F.C.A.), affirming 2018 D.T.C. 1120 (T.C.C.); *Loblaw Financial*, *infra* note 49.

29 Subsection 250(4).

30 *De Beers Consolidated Mines Ltd. v. Howe*, [1906] A.C. 455 (H.L.).

31 In which case, subsection 250(5) will deem the corporation to not be resident in Canada.

32 Pursuant to subsection 2(2).

33 As defined in subsection 5907(11) of the Income Tax Regulations, C.R.C., c. 945 (the "**Regulations**"), and subject to the limitation in subsection 5907(11.2) of the Regulations. A designated treaty country includes a country with which Canada has concluded a tax information exchange agreement, and therefore includes no-tax or low-tax jurisdictions like Bermuda, the Cayman Islands, the Bahamas or Guernsey.

34 The CRA's position is that central management and control must be established in the designated treaty country in order for the affiliate to be resident in that jurisdiction for the purposes of the Regulations regardless of whether the foreign affiliate is deemed to not be resident in Canada for the purposes of the ITA: Technical Interpretation 2000-0054455 dated October 23, 2001; Technical Interpretation 2007-0261551I7 dated October 19, 2010; Document 2009-0316641C6 dated May 1, 2009.

35 For the purposes of Part LIX of the Regulations.

generally will be added to the affiliate's exempt surplus that can be returned to Canada tax-free.[36] Properly structured, residence in a designated treaty country can mean that the captive's insurance or reinsurance income from non-Canadian risks will never be subject to corporate income tax in any country.

b) Foreign Affiliate and Controlled Foreign Affiliate Status

Status as a foreign affiliate is a precondition to any dividends paid by a foreign corporation being deductible when received by its Canadian parent.[37] If a foreign affiliate is a controlled foreign affiliate, or is deemed to be a controlled foreign affiliate, then the foreign affiliate's FAPI will be included in the income of the Canadian parent when earned,[38] subject to a deduction for the grossed-up foreign accrual tax paid by the affiliate.[39] If a foreign corporation is earning active business income and meets the conditions described above, then it is desirable for the foreign corporation to be a foreign affiliate so that exempt surplus dividends can be received tax-free by the Canadian parent. If a foreign affiliate is earning income from property, it is desirable that the foreign affiliate is not a controlled foreign affiliate so that Canadian tax is deferred until dividends are paid to the Canadian parent.

A corporation is a foreign affiliate of a Canadian taxpayer if: (i) it is not resident in Canada; (ii) the taxpayer's equity percentage is not less than one per cent; and (iii) the combined equity percentages of the taxpayer and all related persons is not less than 10 per cent.[40] If the taxpayer owns shares of the non-resident corporation directly, the taxpayer's equity percentage in the non-resident corporation is the taxpayer's percentage ownership of a class of shares of the non-resident corporation in which the taxpayer's percentage ownership is greatest.[41] In other words, if a taxpayer owns, together with all related persons, 10 per cent or more of the shares of any class of the non-resident corporation, the non-resident corporation should be a foreign affiliate.[42]

A foreign affiliate of a taxpayer is a controlled foreign affiliate if: (i) the taxpayer controls the foreign affiliate;[43] or (ii) the taxpayer would control the corporation if it owned all of the shares of the foreign affiliate owned by non-arm's-length persons, any set of up to four arm's-length Canadian shareholders of the foreign affiliate and all persons who do not deal at arm's length with those other Canadian shareholders.[44] Even if a taxpayer does not

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36 See the definitions of "exempt earnings" and "exempt surplus" in subsection 5907(1) of the Regulations. A dividend that is deemed by subsections 5900(1) and 5901(1) of the Regulations to be paid from exempt surplus is deductible from the income of a Canadian corporation that receives the dividend: paragraph 113(1)(a).

37 As subsection 113(1) applies only to dividends received by a Canadian corporation from a non-resident corporation that is a foreign affiliate of the Canadian shareholder.

38 Pursuant to subsection 91(1).

39 Pursuant to subsection 91(4).

40 See the definition of "foreign affiliate" in subsection 95(1).

41 See the definitions of "direct equity percentage" and "equity percentage" in subsection 95(4). For these purposes, each series of shares is deemed to be a separate class: subsection 248(6). This deeming rule is a trap for the unwary in many captive insurance arrangements, especially after the enactment of the tracking affiliate rules.

42 In instances where there are tiered foreign affiliates, the "equity percentage" definition in subsection 95(4) determines the Canadian taxpayer's equity percentage using a percentage of percentage analysis.

43 For these purposes, "control" means *de jure* control, being ownership of enough shares of a corporation to elect its board of directors: *Duha Printers (Western) Ltd. v. R.*, [1998] 1 S.C.R. 795 (S.C.C.) at paras. 35–36, reversing 96 D.T.C. 6323 (F.C.A.), reversing 95 D.T.C. 828 (T.C.C.); *Buckerfield's Ltd. v. M.N.R.*, 64 D.T.C. 5301 (Can. Ex. Ct.) at para. 10.

44 See the definition of "controlled foreign affiliate" in subsection 95(1).

control a foreign affiliate, the affiliate may nevertheless be a controlled foreign affiliate if the taxpayer, together with four other Canadian shareholders and their non-arm's-length groups, controls the affiliate.

The identification of controlled foreign affiliates was complicated further by the tracking affiliate rules enacted in 2018, which apply where a taxpayer owns an interest in a foreign affiliate that tracks less than all of the assets or activities of the affiliate.[45] At a high level, these rules provide that a foreign affiliate may be deemed to be a controlled foreign affiliate or part of the assets and activities of an affiliate may be deemed to be assets and activities of a notional separate corporation (which will itself likely be a controlled foreign affiliate). The tracking affiliate rules are especially relevant to protected cell captive insurers or group captive arrangements and eliminated many of the benefits of captive insurance arrangements marketed to Canadian small and medium enterprises.

c) When Insurance Income Becomes FAPI

At the highest level, FAPI is a foreign affiliate's income from property, including interest, rents, dividends, etc., as well as taxable capital gains, but excluding dividends from other foreign affiliates and taxable capital gains from the disposition of excluded property.[46] Taken at face value, income of a foreign affiliate from insuring or reinsuring risks would not be FAPI because income from insurance or reinsurance would typically be income from business.

This superficial reading is incorrect because of the broad definition of income from property used in the context of the foreign affiliate rules.[47] Income from property not only includes items of income typically characterized as being from a source that is property but is also deemed to include income from an investment business and income that is deemed to be income from a business other than an active business. This expansive definition is important for captive insurance arrangements because both additions to income from property are targeted in part at income from insurance or reinsurance. Balancing out the expansive income from property definition is a relieving rule that deems income of a foreign affiliate that would otherwise be income from property to be income from an active business if the underlying payments were deductible by another foreign affiliate of the same taxpayer in computing its income from an active business.[48]

An investment business of a foreign affiliate includes, among other things, a business of insuring or reinsuring risks unless the taxpayer can establish that: (i) the business is conducted principally with arm's-length persons;[49] and (ii) the affiliate, or the affiliate together with certain other persons, employs more than five employees full time in the

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45 Subsections 95(8) to (12).

46 See the definition of "foreign accrual property income" in subsection 95(1). The term "excluded property" is also defined in subsection 95(1), and generally encompasses assets used in an active business carried on by the affiliate or shares of another foreign affiliate that derive substantially all of their value from assets used in an active business of that other affiliate.

47 See the definition of "income from property" in subsection 95(1).

48 Subparagraph 95(2)(a)(ii), together with the definition of "income from an active business" in subsection 95(1). For greater certainty, the Canadian corporation must have a "qualifying interest," as defined in paragraph 95(2)(m), in both foreign affiliates in order to avail itself of this relieving rule.

49 What it means to conduct business principally with arm's-length persons was recently considered by the Supreme Court of Canada in *Loblaw Financial Holdings Inc. v. R.*, 2021 SCC 51, affirming 2020 D.T.C. 5040 (F.C.A.), reversing 2018 D.T.C. 1128 (T.C.C.).

active conduct of the business.[50] If a foreign affiliate is transacting insurance business with persons other than other foreign affiliates of the same taxpayer that are themselves engaged in an active business, the foreign affiliate will likely be carrying on an investment business and generating FAPI if it does not satisfy both conditions.

Even if the foreign affiliate is not carrying on an investment business, its income from insurance can be deemed to be income from a business other than an active business and therefore income from property. This will happen if the affiliate earns income from insuring or reinsuring risk in respect of persons resident in Canada, property located in Canada or a business carried on in Canada.[51] To backstop these restrictions on earning active business income from insuring or reinsuring Canadian risks, additional restrictions on insurance swap transactions and a specific anti-avoidance rule may apply.[52]

In summary, a captive insurer that is a foreign affiliate of a Canadian taxpayer can generate active business income from an insurance or reinsurance business if the income is derived from other foreign affiliates carrying on an active business or from other non-Canadian risks if the captive employs more than five full-time employees. If the captive insurer derives income from insuring or reinsuring Canadian risks, its income from insurance or reinsurance will most likely be FAPI. If the captive insurer derives income from insuring or reinsuring non-Canadian risks other than those of other foreign affiliates carrying on an active business, its income from insurance or reinsurance should be FAPI unless it has more than five full-time employees.

iii) Loss Reserves

Unlike most taxpayers, insurers — including captive insurers and foreign affiliates carrying on insurance businesses — are entitled to deduct loss reserves,[53] and may also amortize the cost of acquiring most types of insurance policies over the life of the policy.[54] An insurer with positive reserves must include an amount in its income.[55]

The amount of the reserve that may be deducted or the amount of the negative reserve that must be included in income, in all cases calculated net of reinsurance ceded, is determined by formula.[56] The ability to deduct loss reserves means that an insurer will typically only have taxable income where its net premium income exceeds administrative costs and general expenses, amortized policy acquisition costs and loss reserves.

The 2022 federal budget proposed measures that will alter the calculation of insurance reserves because of the transition to the new International Financial Reporting Standards for Insurance Contracts (IFRS 17). Draft legislation to implement these proposals has not been released and, in any event, a review of these proposals is beyond the scope of this paper.

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[50] See the definition of “investment business” in subsection 95(1).
[51] Paragraphs 95(2)(a.2) and (a.23).
[52] Paragraphs 95(2)(a.21), (a.22) and (a.24).
[53] Paragraph 20(7)(c) and Part XIV of the Regulations.
[54] Subsections 18(9) and (9.02).
[55] Paragraph 12(1)(e.1) and subsection 1400(2) of the Regulations.
[56] See subsection 1400(3) of the Regulations in relation to property and casualty insurers, and sections 307, 1401 and 1404 of the Regulations in relation to life insurers.

4. TAX INCENTIVES IN OTHER JURISDICTIONS

It is unclear to what extent tax incentives impact location decisions for captive insurers. Some older research examining location decisions within the United States suggests that there is little correlation between premium tax rates and the size of a state's insurance industry (Grace et al. 2004); many states have comparably low premium tax rates for captives,[57] so there must be some other rationale for the clustering in Vermont, Utah and Delaware. Nevertheless, considering that captive insurance arrangements are often tax-motivated, tax rates may not always be irrelevant.

A. PREMIUM TAXES

Many or most Canadian provinces, including Alberta, impose premium taxes only on insurance business transacted in the province regardless of where the insurer is resident. Premium taxes therefore have limited importance as an incentive for insurance companies in making location decisions, instead impacting the profitability of insuring risks located in the province and, by extension, the decision to transact business in that province.

Not all jurisdictions impose premium taxes on business transacted in that jurisdiction; in other instances, it may be unclear whether premium taxes can be imposed on captives and so only the captive's residence jurisdiction will impose premium taxes.[58] For taxpayers with insurable risks in jurisdictions without local premium taxes, forming a captive in a jurisdiction that does not impose premium taxes on premiums payable to an insurer headquartered in that other jurisdiction means that premium taxes may never become payable.

This is probably why most offshore and onshore jurisdictions where captive insurers are commonly located impose no premium taxes or very low premium taxes. Bermuda and the Cayman Islands do not impose premium taxes at all, Luxembourg does not impose premium taxes on reinsurance and many U.S. states impose premium taxes on captive insurers at very low rates.[59] A jurisdiction attempting to break into the captive insurance space would likely need to adopt an equally favourable premium tax regime to be competitive, and that favourable premium tax regime would need to be a permanent feature of the legislation.

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57 U.S. state premium tax rates as of 2017 have been compiled by Todd et al. (2017).

58 For example, the author's understanding is that 15 USC §8201 is intended to permit the home state of an insured risk to impose premium taxes, but in at least some states the courts have held that premium taxes are not applicable to premiums paid to captive insurers. See *Johnson & Johnson v. Director, Division of Taxation*, 241 A.3d 318 (N.J. 2020) where the New Jersey Supreme Court confirmed this result under New Jersey law.

59 For example, Delaware's premium tax rate on captive insurers is 0.02 per cent for direct premiums and 0.01 per cent for reinsurance premiums: Del. Code tit. 18 §6914(a) and (b). Vermont's premium tax rate on captive insurers is 0.038 per cent on the first US$20 million of premiums and decreases as premium revenue increases: 8 V.S.A. §6014(a).

B. INCOME TAXES

Subject to FAPI-like imputation regimes in the country in which a captive insurer's parent entity is resident, the profits of captive insurers should be taxable only in the jurisdiction in which the captive is resident. At least until such time as legislation implementing the Organisation for Economic Co-operation and Development's (OECD) two-pillar project is implemented broadly (see below), income taxes are therefore an obvious lever that can be used to attract firms.

Most offshore jurisdictions where captive insurers are commonly incorporated impose no income taxes or impose income taxes at a very low rate. Bermuda and the Cayman Islands do not impose income taxes at all, Barbados imposes income tax at an effective rate of zero per cent[60] and Guernsey's income tax rate is zero per cent if all insured risks are foreign risks.[61] These are permanent advantages and not temporary concessions, absent any change in law.

Onshore jurisdictions may attempt to compete by eliminating subnational income taxes. For example, both Vermont and Delaware do not impose corporate income taxes on captive insurers formed in those states.[62] Again, these exemptions from state income taxes are not temporary or time-limited, absent a change in law. While a Vermont or Delaware captive will still be subject to U.S. federal income taxes, the elimination of state income taxes may be enough to make an onshore captive competitive, especially for more marginal captives — the firm can save some tax while avoiding the costs and hassle of circumventing excise taxes or imputation regimes that may apply when an offshore captive earns premium income. Attracting marginal captive insurance business from within the United States is worthwhile given the large volumes of insurance business transacted in the United States.

In Canada, British Columbia initially refunded all provincial corporate income taxes payable by a captive insurer to the extent that the captive earned income from insuring foreign risks.[63] The effect of this refund was that a B.C. captive insuring foreign risks would only be subject to federal income tax, at a reasonably competitive rate (15 per cent).[64] However, this incentive was repealed after September 11, 2017.[65] The termination of this tax incentive appears to have been an outcome of the 2017 B.C. election campaign, during which the B.C. NDP characterized the refund as a "shady give-away scheme" that did not produce obvious benefits for B.C. taxpayers (Todd 2017). Following the repeal of the tax rebate, all income of a B.C. captive is taxed at the combined B.C.-federal 27 per cent rate. It is unclear what impact this income tax change had on captive formation in B.C.; as noted above, B.C. is not viewed as a favourable jurisdiction from a regulatory perspective.

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60 Section 43(3A) of the *Barbados Income Tax Act*, Cap. 73, as amended by section 7 of the *Barbados Income Tax Amendment (No.) Act, 2018*.
61 Paragraph 2(2)(d) and the fifth schedule of the *Income Tax (Guernsey) Law, 1975*.
62 Del. Code tit. 18 §6914(d); 8 V.S.A. §6014(g).
63 Sections 17 and 18 of the *British Columbia International Business Activities Act*, S.B.C. 2004, c. 49.
64 Being the default 38 per cent rate in subsection 123(1), less the 13 per cent general rate reduction in subsection 123.4(2), less the 10 per cent provincial abatement in 124(1).
65 Section 8.2 of the *British Columbia International Business Activities Act*.

5. THE CHANGING INTERNATIONAL TAX LANDSCAPE

Provided that Alberta can create a favourable regulatory regime for captive insurance, recently enacted or recently proposed multilateral tax avoidance measures may have the effect of making Alberta a more competitive location for captive insurers. At a high level, these measures will have the effect of raising the costs of creating and maintaining a captive in a tax haven jurisdiction like Bermuda or the Cayman Islands and will effectively require all captives to pay tax at a minimum rate of 15 per cent regardless of residence.

A. OECD BEPS ACTION 5 MEASURES

One of the focuses of the OECD's base erosion and profit-shifting (BEPS) project was the elimination of harmful tax practices described in BEPS Action 5. According to the OECD and the Inclusive Framework, harmful tax practices include the shifting of income to nominal or no-tax jurisdictions without carrying on substantial activities in those jurisdictions.

For captive insurers, the OECD's concept of substantial economic activities includes predicting and calculating risk, insuring or reinsuring risks and providing client services (OECD 2015). To ensure that captive insurers established in a nominal or no-tax jurisdiction are undertaking substantial economic activities, the OECD and the Inclusive Framework required that these jurisdictions enact substantial economic activities laws. To meet minimum standards, these laws must: (i) define the core income-generating activities for insurers; (ii) ensure that core income-generating activities are undertaken either by the insurer or in the jurisdiction; (iii) require that the insurer have a minimum number of adequately trained full-time employees and incur adequate operating expenses; and (iv) have a transparent compliance mechanism and an effective enforcement mechanism (OECD 2019).The economic substance laws enacted by nominal or no-tax jurisdictions to meet the OECD's minimum standards are broadly similar. To use Bermuda's laws as an example, a captive insurer must have a substantial economic presence in Bermuda,[66] which means that it must:

- Be managed and directed in Bermuda;
- Undertake its core economic activities — which are prescribed to include predicting and calculating risk, insuring or reinsuring against risk, providing client services and preparing regulatory reports — in Bermuda;[67]
- Maintain adequate physical presence in Bermuda;
- Employ adequate full-time employees with suitable qualifications in Bermuda; and
- Incur adequate operating expenditures in Bermuda.[68]

The government of Bermuda has issued administrative guidance that explains that adequacy must be determined in context, having regard for the nature, scale and complexity of the business (Government of Bermuda 2021). Core income-generating

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66 Subsection 3(1) of the *Economic Substance Act, 2018* (Bermuda).
67 These prescribed core economic activities are found in subsection 8(2) of the *Economic Substance Regulations, 2018* (Bermuda).
68 Subsection 3(2) of the *Economic Substance Act, 2018* (Bermuda).

activities may be carried on by contractors rather than by the Bermuda entity's employees, so long as they are carried on in Bermuda; this will impact the number of full-time employees and the amount of physical space required in Bermuda. What appears non-negotiable is that the captive insurer has regular directors' meetings in Bermuda, ensures that all core insurance activities are carried on (by someone) in Bermuda and maintains some physical presence in Bermuda.

All Bermuda captive insurers are required to file annually an information return disclosing information that will permit the registrar of companies to verify compliance with the economic substance regime.[69] Failure to establish substantial economic presence may be disclosed to the tax administrator for the jurisdiction in which the ultimate parent entity is resident.[70] Failure to file the information return can result in penalties ranging from US$7,500 to $250,000, and may result in a court ordering that the captive terminate its business or be struck.[71] Providing false information in the information return is a criminal offence.[72]

Establishing and maintaining economic substance in Bermuda, the Cayman Islands or a similar jurisdiction imposes additional costs on the captive (in addition to the cost of, for example, holding regular in-person directors' meetings in the residence country). If the captive insurer is already outsourcing its insurance functions to residence-country insurance administrators, those additional costs may be incremental. In contrast, if the captive insurer was relying on employees of its ultimate parent entity to undertake its core activities, the increase in cost may be material. Since onshore insurers are not subject to economic substance minimum standards, onshore jurisdictions may be increasingly viable even without the same opportunities for tax avoidance.

B. OECD PILLAR TWO (GLOBE) PROPOSALS

For large enterprises with captive insurers, the OECD's proposed Pillar Two rules are potentially significant as they may drastically reduce the income tax savings available from maintaining a captive in Bermuda, the Cayman Islands, Barbados, Guernsey or other low-income tax jurisdictions, sometimes referred to as tax havens (OECD 2021a). If enacted by most OECD nations, the Pillar Two proposals would effectively force the ultimate parent entity of a multinational enterprise (MNE) to pay tax at an effective rate of 15 per cent on profits from every jurisdiction in which the MNE operates. If the ultimate parent entity would be subject to tax on profits in its home jurisdiction at a 25 per cent rate, the GloBE regime reduces the potential income tax savings by 60 per cent from shifting profits to tax haven captive insurers.[73]

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69 Ibid., section.
70 Ibid., section 6.
71 Ibid., section 13
72 Ibid., section 14
73 Suppose an in-scope ultimate parent entity were subject to residence country tax at a 25 per cent effective rate and a captive insurer in the group were subject to residence country tax at a zero per cent effective rate, with the result that shifting income to the captive insurer would (absent Pillar Two) eliminate 100 per cent of the tax payable on that income. If a 15 per cent minimum tax applies, then the rate reduction on the income of the captive insurer is only 10 per cent (25 per cent – 15 per cent), meaning that the potential tax savings have been reduced by 60 per cent.

A firm is within the scope of the GloBE regime if it is multinational — meaning that the group has at least one entity or permanent establishment not located in the jurisdiction of the ultimate parent entity — and has consolidated financial statement annual revenues of at least 750 million euros. Although some corporate groups with captive insurers may not meet the revenue threshold, and others may not be MNEs because they are purely domestic enterprises, it is reasonable to expect that many or most such corporate groups will be in scope.

The core of the GloBE regime is the income inclusion mechanism, which causes the ultimate parent entity to include in its income an amount that will generate sufficient residence country tax payable to increase the total tax on the undertaxed source country to the 15 per cent minimum rate.[74] If the ultimate parent entity is not resident in a jurisdiction that has enacted an income inclusion mechanism, then source countries may deny deductions for payments to entities in low-tax or no-tax jurisdictions to increase the effective rate to the 15 per cent minimum rate. Finally, if a payer entity is resident in a developing country and the payee entity is resident in a nominal tax jurisdiction, the source country may impose withholding taxes on interest, royalties and other similar payments to increase the effective tax rate to nine per cent. The effective tax rate is calculated on a jurisdiction-by-jurisdiction basis, so MNEs cannot avoid the potential application of the GloBE rules by averaging the effective tax rates of its operating subsidiaries in high-tax jurisdictions and captive insurers in low-tax jurisdictions. In computing the total income for entities in a jurisdiction, MNEs may deduct five per cent of their total payroll costs and five per cent of the carrying value of eligible tangible assets;[75] these substance-based exclusions are unlikely to materially benefit captive insurers, which will typically have few employees and minimal non-financial assets. Potentially more relevant for small captives is a de minimis exclusion for entities in jurisdictions with less than 10 million euros of revenue and one million euros of net income.

The United States has already enacted its global intangible low-tax income (GILTI) regime,[76] which is similar in many respects to the proposed GloBE regime, but its status as a compliant GloBE regime is uncertain in its current form.[77] Most Inclusive Framework nations have a more straightforward path to implementation than the United States, and all OECD nations have agreed to enact GloBE-compliant legislation in 2022, with effect in 2023 (OECD 2021b). A multilateral convention will be developed in 2022 to allow for the application of withholding taxes by developing nations, and this multilateral convention or a second multilateral convention may also be used to co-ordinate GloBE legislation between countries.

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74 Under the current Pillar Two proposals, the residence country in which an undertaxed controlled foreign company is resident would have the option of heading off the income inclusion for the ultimate parent entity by imposing a qualified domestic minimum top-up tax (QMDTT) to bring the effective tax rate on the income of those controlled foreign companies to 15 per cent.

75 These rates will initially be 10 per cent of total payroll costs and 10 per cent of the carrying value of eligible tangible assets but will be decreasing to five per cent over 10 years.

76 26 USC §951A.

77 The U.S. Treasury's FY2023 budget proposals and H.R. 5376 *Build Back Better Act* would amend the GILTI to make it a Pillar Two-compliant regime. The *Build Back Better Act* appears unlikely to pass the Senate and it is unclear whether the FY2023 budget proposals will be enacted.

Although the application of the GloBE rules will vary between countries based on the legislation ultimately enacted, captive insurers earning base-eroding premium income are precisely the types of entities targeted by the GloBE proposals. If an MNE group is in scope, it is likely that a tax haven resident captive insurer will generate tax liabilities; any captive small enough to escape using one or more carve-outs is probably not economical because of the economic substance rules. It appears that only MNEs with less than 750 million euros of consolidated revenue, but that are nevertheless large enough to operate a captive insurer with economic substance, will fully realize the benefit of tax haven residence for their captives.

6. IMPLICATIONS AND OPPORTUNITIES FOR ALBERTA

Recent domestic legislative amendments and international tax proposals have restricted the opportunities to use captive insurance and increased the cost of the captive insurance arrangements that remain. The Canadian tracking affiliate rules have brought many industry association-sponsored group captive arrangements into the FAPI web. Economic substance legislation — assuming it is enforced in a manner consistent with its purpose — will increase the costs of maintaining an offshore captive insurer. The GloBE proposals, if enacted as agreed upon by the Inclusive Framework members, will increase the effective tax rate on tax haven captive insurance profits from zero per cent to 15 per cent, thereby making the costs of maintaining an offshore captive less palatable for many MNEs.

A. DOMESTIC CAPTIVE INSURANCE OPPORTUNITIES

Attracting captive insurance business from Canadian firms that have non-tax reasons for captive insurance may not require much further action by Alberta, provided a favourable regulatory regime is created. The combined federal-Alberta general corporate rate (23 per cent) is lower than the rate in any other province and close enough to the GloBE minimum rate (15 per cent). It is not certain that interprovincial income shifting through captive insurance would be prevented under existing law, as the courts in common-law provinces have held that general provincial anti-avoidance rules do not apply to these sorts of arrangements.[78] This is especially true where the captive insurance arrangement is commercially motivated and not tax motivated.

The opportunity to reduce or avoid non-tax costs through an onshore captive may be an attractive financial proposition for Canadian firms. Using an Alberta captive would avoid the need to: deal with offshore legal regimes that can be slow and cumbersome; establish central management and control in an offshore jurisdiction; satisfy foreign affiliate compliance requirements; avoid the creation of FAPI; satisfy economic substance rules; and manage GloBE reporting. Further, an Alberta captive could be used to insure Canadian risks directly without incurring federal excise taxes or pay a toll charge to a fronting insurer in Canada, and an Alberta captive could insure or reinsure Canadian risks without generating FAPI.

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[78] See, for example, *R. v. Husky Energy Oil Inc.* (2011), 514 A.R. 181 (Alta. Q.B.) at paras. 72–73, affirmed [2012] 11 W.W.R. 282 (Alta. C.A.), leave to appeal refused March 7, 2013 (S.C.C.); *Canada Safeway Ltd. v. Alberta* (2012), 352 D.L.R. (4th) 566 (Alta. C.A.), affirming [2011] 10 W.W.R. 526 (Alta. Q.B.), leave to appeal refused (2013), 447 N.R. 400 (note) (S.C.C.).

If Alberta is going to pursue domestic insurance business through captives, one possible concern was that other provinces would rely on retaliatory premium taxes to protect both their premium tax base and their income tax base. Prior to 2022, Alberta's regulatory charge on unlicensed insurance was far higher than premium taxes imposed by other provinces on unlicensed insurance and would effectively preclude a captive insurer licensed in another province insuring risks in Alberta. An Alberta captive would have been similarly unviable as a direct insurer for domestic risks if subject to retaliatory premium taxes, although still viable if reinsuring domestic risks via a fronting insurer. Reducing the regulatory charge on unlicensed insurance to a rate consistent with other provinces reduced the risk of retaliation by other provinces via premium taxes; it appears that the Alberta legislature was aware of this concern and responded by reducing the regulatory charge on unlicensed insurance.

If Alberta wanted to use tax policy to aggressively court domestic captive insurance business, a temporary or permanent reduction or elimination of provincial income taxes on captive insurance profits of Canadian-controlled captives could be considered. The federal corporate income tax rate (15 per cent) is the same as the GloBE minimum effective rate. If Parliament enacts the GloBE proposals, then, subject to taxable income calculation differences, eliminating provincial income taxes would place Alberta captives and offshore captives on an even footing for Canadian MNEs even before accounting for non-tax savings. However, there is no obvious economic efficiency, fairness or tax simplification justification for a provincial income tax reduction or elimination. Furthermore, businesses with permanent establishments in Alberta would have an incentive to shift income from operating entities to captive insurers to eliminate provincial income taxes; Alberta would therefore risk eroding its own corporate income tax base.

Other provinces or the federal government could retaliate against a reduction or elimination of provincial income taxes for captives in two ways. First, subject to the requirement to maintain a common tax base under tax collection agreements and not deviate without the consent of the minister of Finance,[79] provinces could amend their provincial income tax laws to deny deductions for insurance premium payments to Alberta captives. Second, the federal government could, at the behest of one or more provinces, restrict the provincial abatement to not apply to Alberta captives. Both alternatives for retaliation would require meaningful effort and would probably not be considered unless the revenue losses for one or more other provinces was significant.

While it is theoretically possible that other provinces could retaliate by creating their own special tax regimes that would not tax income earned from Alberta sources, this is less plausible for non-Quebec provinces because doing so would require the consent of the Department of Finance. Although the federal government is not obligated to administer provincial corporate income taxes to protect Alberta's tax base,[80] it is doubtful that the federal government would want to be perceived as facilitating interprovincial tax competition, even if retaliatory.

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79 See, for example, section 3.4 of Annex B to the *Memorandum of Understanding Concerning a Single Administration of Ontario Corporate Tax between Canada and Ontario*.

80 As, for example, paragraph 3.4(b) of Annex B to the *Memorandum of Understanding Concerning a Single Administration of Ontario Corporate Tax between Canada and Ontario* only prevents Ontario from adopting tax programs that impact the tax base of other provinces that have tax collection agreements with Canada.

Eliminating provincial income taxes for captive insurers while only imposing premium taxes on Alberta risks would not raise tax revenue for Alberta. An industry-specific tax reduction or exemption likely would not be efficient, and a base-eroding tax reduction or exemption for large businesses cannot be justified by equity considerations. Tax elimination for captive insurers could probably only be justified if the government of Alberta had a pressing or substantial reason for wanting to subsidize a captive insurance industry or the insurance industry more generally. Tax reductions for captive insurers short of an exemption might be justifiable if the government of Alberta believed that it could raise incremental revenue and might also be justifiable if there were pressing or substantial reasons for an industry subsidy. At the same time, the need for an industry subsidy is undercut by the fact that economic substance requirements will raise the cost of offshore captive insurers and may incentivize multinational groups to move captives onshore.

Other than a rate reduction, there are limited opportunities to use the tax system to incentivize the location of captive insurers in Alberta. Captive insurers are unlikely to have material capital expenditures or to have a meaningful workforce, so traditional tax expenditure options like investment tax credits are unlikely to provide strong incentives. Departing from the federal income tax base to allow for larger reserve deductions or to allow investment tax credits based on notional investment are tantamount to a rate reduction, without the benefit of simplicity.

B. INTERNATIONAL CAPTIVE INSURANCE OPPORTUNITIES

Using tax policy to attract international captive insurance business will likely prove more difficult, if for no other reason than Alberta lacks the captive insurance infrastructure available in offshore jurisdictions like Bermuda or onshore jurisdictions like Vermont. Non-Canadian firms that are not large enough to be within the scope of the GloBE rules would have the option of paying zero per cent in a tax haven jurisdiction; even if Alberta were to exempt captive insurers from provincial income tax, the cost savings of not having to comply with economic substance legislation would probably not justify the loss of tax savings. Captive insurers that are part of MNE groups that are within the scope of the GloBE rules would be subject to the 15 per cent minimum tax, but these captive insurers may be generating large enough profits that the eight per cent spread between the effective tax rate in a tax haven and the combined federal-Alberta 23 per cent corporate tax rate would result in a substantial incremental tax cost.

Alberta does have some advantages relative to other jurisdictions, however. The combined federal-Alberta 23 per cent corporate tax rate is lower than in many OECD and non-OECD jurisdictions,[81] and Alberta's non-imposition of premium taxes on risks located outside of Alberta is competitive with premium tax regimes in tax havens. Unlike most tax haven residents, Alberta captives will be able to avail themselves of Canada's expansive tax treaty network. As a resident of a high-tax jurisdiction, an Alberta captive insurer may be outside of the scope of controlled foreign company rules in many OECD countries and therefore attractive to MNEs that need captive insurance but cannot otherwise avoid the application of a FAPI-type regime.

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[81] However, the 23 per cent rate is only slightly below the OECD average (whether using the GDP-weighted average or simple average), so Alberta's corporate income tax rates would be most competitive relative to countries that are well above the OECD average: see Bazel and Mintz (2020).

Assuming that adequate captive insurance infrastructure can be developed, Alberta would likely need to either eliminate or substantially reduce the provincial income tax rate for captives to be internationally competitive. Any reduction may need to be applicable to all captives and not only to captives insuring non-Albertan or non-Canadian risks and may also require economic substance. Ring fencing from the domestic economy, especially with no requirement for economic substance, could result in any tax reduction for Alberta captive insurers being branded as a harmful tax practice by the OECD.[82] If this were the case, then the federal government may be obliged to deny the harmful tax benefits.

Even if Alberta were to eliminate the provincial income tax on captive insurers, it is unclear whether this would provide enough of an incentive to locate non-Canadian captive insurance business in Alberta. MNEs would have no reason to believe that Alberta would be tax competitive over the long term; a federal corporate tax rate increase or a change in government in Alberta followed by a provincial tax rate increase or a repeal of the captive insurer tax exemption would leave an MNE worse off than if its captive were resident in a tax haven. Unlike most tax havens, it is doubtful that Alberta could secure the sort of all political party buy-in to the concept of tax exemptions for large MNEs that would offer assurance of stable tax treatment.

Again, provincial income tax reductions or exemptions for base-eroding income of non-Canadian MNEs is difficult to justify on revenue raising, efficiency or equity grounds. There are also few tax expenditure options short of a rate reduction or a disguised rate reduction that would incentivize non-Canadian MNEs to locate captive insurance business in Alberta. Like domestic captive insurance business, the government of Alberta would need good reasons to want to attract non-Canadian captive insurance business to justify any tax expenditure.

In summary, there is probably limited opportunity for Alberta to attract captive insurance business from non-Canadian MNEs. Alberta could reasonably expect greater success in attracting captive insurance business from Canadian firms, given the potential tax compliance savings and the ability to insure or reinsure Canadian risks without adverse tax consequences. Retaliatory measures by other provinces or the federal government would be unlikely unless Alberta were to reduce or eliminate provincial income taxes for captives.

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82 For a discussion of what constitutes a harmful tax practice, see *OECD*, *supra* note 73 at 13–14.

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