Insuring Transfer Pricing Risks: 2020 Market Report

July 2020

Aon
Empower Results®

Introduction

Tax insurance protects against the additional tax and associated costs which could arise if a tax position, adopted in good faith, is unexpectedly challenged by a tax authority. Over the last 10 years, tax insurance has developed into a thriving and increasingly sophisticated part of the specialty insurance market.

However, for various reasons, discussed in this paper, insurers' appetite to cover transfer pricing risks has historically been limited. In Q2 2020, Aon's tax insurance team carried out a survey and a series of interviews with key insurers - to see whether this had changed. In addition, Aon has consulted closely with Timothy Holmes, head of IDTP (International, Deals and Transfer Pricing) at PwC Denmark, and his team who have provided insightful commentary based on their first-hand experience as transfer pricing advisors.

The results are set out in this paper. In summary, there is now insurer appetite, within certain parameters, to insure transfer pricing risks both within a warranty and indemnity insurance ("W&I") policy and a standalone tax insurance policy.

This paper provides a snapshot of the state of the EMEA market as at Q2 2020. We hope it will be a useful reference for corporate tax directors, M&A professionals and advisers who are grappling with their uncertain transfer pricing positions.

Tax insurance – a valuable tool for the TP specialist

Traditionally a taxpayer would manage a transfer pricing risk by establishing transfer pricing policies and preparing relevant documentation. In case of a dispute with the tax authorities, a conclusion could be obtained via the regular objection and appeal procedures, a negotiated settlement, an out of court arbitration or a Mutual Agreement Procedure (a mechanism laid down in tax treaties to ensure that taxation is in accordance with the tax treaty and therefore avoiding economic double taxation).

Another way of managing the risk of transfer pricing disputes with tax authorities is to conclude an Advance Pricing Agreement (APA). An APA is an ahead-of-time agreement between taxpayers and tax authorities regarding the terms and conditions for one or more controlled transactions for a fixed period. As it is forward looking, the APA assumes a fixed set of facts and therefore may not be valid if the taxpayer's business model changes during the term in which it is in force, as the arm's length pricing agreed is based on that business model. Also, although the certainty generated is valuable to most multinational groups, obtaining an APA can be a long and resource consuming process particularly in a bilateral or multilateral arrangement.

A standalone tax insurance policy can act as an alternative protection tool for taxpayers. Businesses can benefit from the strategic use of tax insurance to manage their contingent transfer pricing tax exposures both in an M&A context and when there is no transaction involved. The insurance market has matured and with it the insurers' willingness to entertain tax risks of different kinds.

Here are the key benefits of transfer pricing insurance:

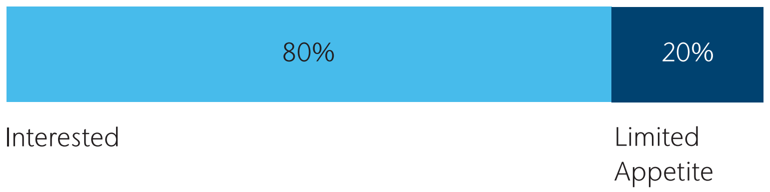
- Transfers an uncertain liability (the tax payable due to a future transfer pricing adjustment) from the insured to the insurer. For the insured this means certainty around costs related to the risk, i.e. the quantified insurance premium.
- Under a tax insurance policy, the insurer will pick up the costs of any future dispute which arises in the future in relation to the risk.
- Insurers have appropriate transfer pricing advisors on hand to assess the insurability of the risk. If the risk is insurable, the analysis will move to the next level of detail and a thorough review of the supporting documentation. It is a streamlined process which can move at pace if required – often much more quickly than an APA process.

Transfer pricing and risk management

Transfer pricing has been a key area of tax authority focus and occasional controversy over the last decade. The Base Erosion and Profit Shifting (BEPS) Actions, issued in October 2015 have only increased the risks in this area. Because of the subjective nature of transfer pricing rules and the mismatch in objectives of tax authorities and taxpayers, the risk of adjustments to taxable income, double taxation, and potential for interest and penalties can be substantial. This is even the case for multinational enterprises (MNEs) that make good-faith efforts to comply with transfer pricing rules, taking specialist advice in order to do so.

The post-BEPS environment and the wide-range of transfer pricing issues globally creates a need for tools which can provide certainty for MNEs by managing transfer pricing risk. In Q2 2020, Aon undertook a market survey to establish the appetite of insurers to cover this type of risk. This paper sets out our analysis.

What is your current appetite for transfer pricing risks?



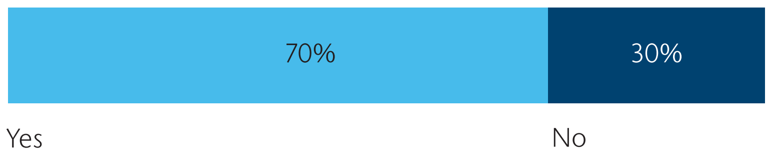
Aon's comment: Our survey of insurers in Q2 2020 shows that the market is open to insuring transfer pricing. Our survey suggests that there has been a move away from automatic exclusion of this type of risk.

> "We have bound several specific transfer pricing risks. These mostly relate to M&A transactions where the seller and buyer could not agree on how to manage the perceived risk (e.g. indemnity vs price chip).
> **– EMEA-based insurer**

W&I insurance and transfer pricing: a brief history

Readers who have experience of using W&I insurance in M&A deals will probably know that such policies typically carve out various tax issues "by default". Amongst these standard carve outs, are losses caused by challenges by a tax authority under transfer pricing legislation.

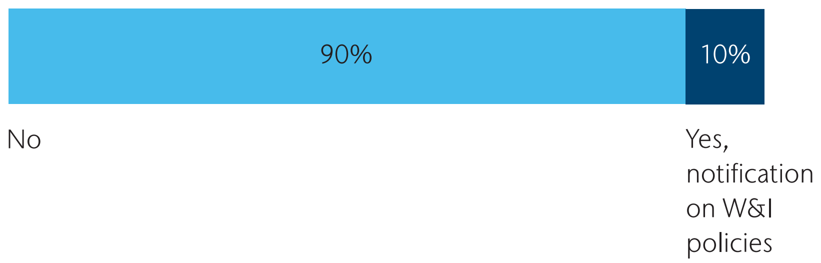
Does your standard W&I policy automatically exclude transfer pricing loss?



Aon's comment: Several insurers have moved away from an automatic W&I transfer pricing exclusion and will only exclude if the facts and circumstances of the deal necessitate it.

The reasons for transfer pricing risks being excluded are somewhat shrouded by history. In part, the exclusion reflects the insurers' perception that transfer pricing is an area of heightened risk – there have been several W&I claims notifications in this area.

Have you experienced any W&I claims or notifications in relation to transfer pricing?



Aon's Comment: It is interesting to see that insurers' perception that transfer pricing is highly risky does not seem to be matched by actual claims.

Based on discussions with advisors we have the impression that there is a "vicious circle" effect – tax due diligence reports on insured M&A deals may not carry out a deep review of the transfer pricing position of the target; to some extent because the parties believe that the W&I insurance will never cover transfer pricing risks. In turn, insurers refuse to cover the transfer pricing due to the lack of detailed due diligence; and the cycle continues.

There are circumstances where a specific transfer pricing risk is identified in the M&A due diligence process and this is still covered under the W&I – typically in exchange for an increased policy premium. In these cases – the general transfer pricing exclusion would remain in the policy, albeit with a specific carve out from the exclusion in relation to the specific issue being covered.

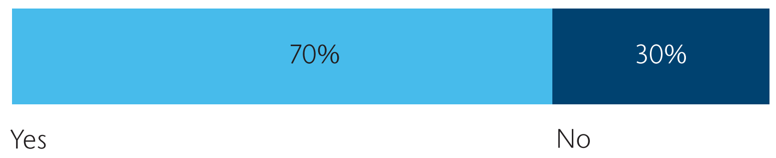
Aon's Comment: There has been a trend of "mission creep" in the scope of the "typical" W&I transfer pricing exclusion. Such exclusions sometimes now attempt to include interest barrier caps, anti-hybrid rules, rules that treat interest payments as dividends etc within the scope of the exclusion. This is point to monitor closely when using W&I.

"There are some occasions where we have covered identified transfer pricing risk in a W&I policy for an additional premium. Normal W&I deductibles would apply for this affirmatively covered risk."

– Global insurer

There are also occasions where insurers are willing to remove the transfer pricing exclusion from the W&I policy altogether.

Have you ever removed the transfer pricing exclusion in your W&I policies?



Aon's comment: This demonstrates the insurance market's interest in covering transfer pricing risks where possible. Using our in-house expertise, Aon can provide upfront advice on the insurability of a transfer pricing risk and manage the process effectively.

"We approach transfer pricing always as a potential exclusion. In approximately 20% of our W&I policies there would be no transfer pricing exclusion."

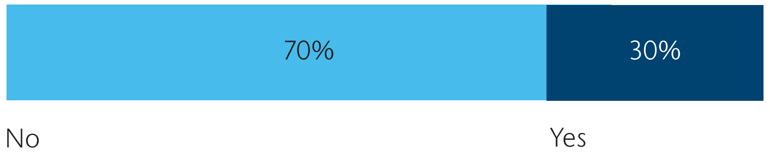
– EMEA-based insurer

Alternatively, a transfer pricing risk identified in a W&I process may be better covered in a standalone tax insurance policy. This may be in circumstances where the W&I insurer is not able to offer coverage under the W&I policy - or it could be the preference of the insured to get competitive pricing from the market by running a full marketing process through their broker. In addition, the standalone policy route can be more streamlined to execute including positive coverage in a W&I policy which can be complicated in comparison to using a tailored and targeted tax policy wording.

The emergence of tax insurance to cover TP issues

The tax insurance market has developed rapidly over the past five years and with this growth the market's willingness to look at transfer pricing risk has increased. Tax insurance, which is sometimes confused with W&I insurance but is in fact a different product, provides a targeted protection against a specific, identified tax issue. Many different issues can be covered, including transfer pricing positions.

To date, have you bound any transfer pricing risks under a tax insurance policy?



Aon's comment: The underlying nature of the risks which have been insured vary in size and subject matter which demonstrates the flexibility of the tool.

Based on our own market experience and the results of our insurer interviews, we have considered various types of transfer pricing risk and whether they may be insurable. If insurable, coverage would be either under a tax insurance policy on a "standalone" basis, or alternatively, where an M&A deal is underway and W&I insurance is being used, under the W&I cover.

ISSUE	DESCRIPTION	INSURABILITY
Lack of complete transfer pricing documentation	Taxpayer has not prepared the required transfer pricing documentation	If there is a clear gap between the transfer pricing documentation "on file" and documentation which the law requires, the consequences of this deficiency are unlikely to be insurable. However, we have placed policies where the requirement to make a particular notification or keep a particular record is not "black and white". Where there is a tenable (albeit not risk-free) position that the absence of the paperwork is acceptable, the risk of a charge being imposed by the authorities may be insurable. Based on our discussions with insurers, for some a lack of documentation will prevent them considering the risk. However, others are more willing to undertake their own assessment of the risk with the assistance of their own transfer pricing advisers.
Inconsistency between operating model and transfer pricing policies	Target has implemented transfer pricing policies which differ from operating reality of the group	Some inconsistencies between the operating model and transfer pricing may be hard to avoid. The insurance market will consider a risk if the inconsistency between operations and model has a limited impact on the transfer pricing. For example, a multi-national has implemented a transfer pricing model with a Principal and Limited Risk Distributors ("LRDs"). It turns out that the functionality of the LRDs is slightly more than what is typically seen and what has been assumed in the transfer pricing analysis. If it can be verified that such additional functionality falls within a "margin of appreciation", it may very well be that the associated transfer pricing risk can be insured. **Comment from PwC** Deviations away from benchmarks or compliance with "faulty" benchmarks are of course relatively simple to identify and may be interesting to insure for some taxpayers.

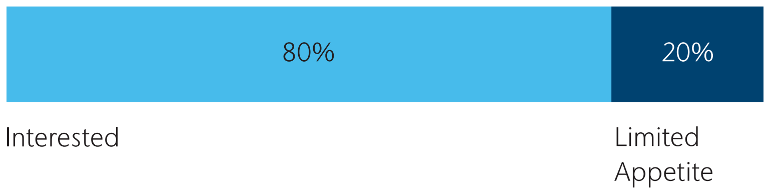
ISSUE	DESCRIPTION	INSURABILITY
Lack of compliance with transfer pricing policies	Target does not comply with the transfer pricing policies, e.g. wrong remuneration.	The main question here is if the actual remuneration applied leads to an arm's length outcome. If an insurer can get comfortable that that is the case, this could be insurable. Clearly if the payments that have been made are unsupportable, insurance will not be an available solution.
Transfer pricing audits	Target has an ongoing transfer pricing audit/case with one or multiple jurisdictions.	The insurance market is now more willing than ever to look at risks which are under audit or in litigation. However, insurability will be fact dependent and there are many insurers who will not look at any risk where a tax authority has started enquiring into an issue and/or has made an assessment/adjustment. **Comment from PwC** We see significant proportion of cases solved, over time, through MAP and similar processes which eliminate double taxation and limit a Group's tax cost to a potential rate difference. On older year cases, however, interest and surcharges etc on unpaid taxes can be more material than the tax itself and this cost is not normally netted out through MAP. This interest element on top of the netted tax risk could be a risk worth managing through insurance due to the potential size.
Interest level on intercompany financing	Risk arises in relation to a loan interest rate, either due to incorrect details of the benchmark, incompliant use of a benchmark or lack of benchmark.	In Aon's experience this is an issue which insurers are willing to quote for and insure, in the right circumstances. "Our focus is on the price of interest charged on shareholder debt because of the data available. We will look at other risks, but often the benchmarking is insufficient for underwriting purposes. We do not seek to repeat the transfer pricing analysis, but rather test the methodology and application thereof." **– EMEA insurer**

ISSUE	DESCRIPTION	INSURABILITY
Transfer pricing in restructuring	Functions, risks or assets are being transferred within the group.	The amounts involved are typically substantial e.g. IP transfers. Insurers will consider covering restructurings if appropriate analysis has been done as to: • whether remuneration is due; and • the arm's length valuation of assets transferred (and to a lesser extent functions and risks). We have previously issued policies covering (amongst other things) TP risks arising on a intragroup transfer and migration of IP. **Comment from PwC** Restructurings in their various forms can be complex, high value issues which can create a level of risk and uncertainty even when properly managed. This is an area where taxpayers could look to sophisticated insurers to discuss potential insurance in order to manage the risk / cost.
Lack of payments for security guarantee	There are no payments for intercompany guarantee security being provided	This is often a grey area and insurability will depend on jurisdiction and the specific factual matrix.

Related Risks

We have seen an increase in enquiries relating to State Aid risk and the extent to which the EU Commission will look into historic tax rulings. Transfer pricing tax rulings have been challenged by the Commission using State Aid rules in the past; for example, where the Commission considers that the tax ruling endorses a transfer pricing methodology which does not correspond to market conditions and, in the Commissions eyes, provides an unfair advantage to the taxpayer. State Aid is potentially insurable and tax insurance could provide protection in this area – on a case by case basis.

More generally, what is your appetite to take "valuation" (including transfer pricing) type risks under tax or contingent liability policies.



Aon's comment: Insurance can help manage uncertainty surrounding the value of an asset. We have seen increased appetite for valuation risks and we expect this area to grow as insurer capabilities increase.

The process

Below we are summarising the standard process from initial enquiry to policy binding.

Transfer pricing risk identified

Enquiry with Aon's specialist tax team

Aon will approach the insurance market to secure heads of terms

The preferred insurer will begin underwriting the risk

The policy binds and insurance premium and legal costs become due

Contacts

David McCann
Executive Director
david.mccann@aon.co.uk
Tel: +44 207 086 7071

Andreas Papantonopoulos
Director, DACH
andreas.papantonopoulos@aon.de
Tel: +49 6929 7273 226

Anka Taylor
Executive Director
anka.taylor@aon.co.uk
Tel: +44 207 086 4833

Annabelle Trotter
Associate Director
annabelle.trotter@aon.co.uk
Tel: +44 207 086 0429

Rebecca Hennessey
Associate Director
rebecca.hennessey@aon.co.uk
Tel: +44 207 086 0761

Helen Chapman
Executive Director
helen.chapman@aon.co.uk
Tel: +44 207 086 0735

About Aon

Aon plc (NYSE:AON) is a leading global provider of risk management, insurance brokerage and reinsurance brokerage, and human resources solutions and outsourcing services. Through its more than 50,000 colleagues worldwide, Aon unites to empower results for clients in over 120 countries via innovative risk and people solutions.
For further information on our capabilities and to learn how we empower results for clients, please visit: http://aon.mediaroom.com.

Important Notice

The information contained herein and the statements expressed are of a general nature and are not intended to address the circumstances of any particular individual or entity. Although we endeavor to provide accurate and timely information and use sources we consider reliable, there can be no guarantee that such information is accurate as of the date it is received or that it will continue to be accurate in the future. No one should act on such information without appropriate professional advice after a thorough examination of the particular situation.

Aon UK Limited is authorised and regulated by the Financial Conduct Authority.

aon.com

AON
Empower Results®