MARSH JLT SPECIALTY

PRIVATE EQUITY AND MERGERS & ACQUISITIONS

Risk Management for Transfer Pricing – the Insurance Solution

Defending your company's transfer pricing (TP) position with the tax authorities can be a daunting task. Uncertainties in benchmarking methodologies, a lack of comparables in certain cases, and a somewhat subjective nature of arm's length pricing determinations have previously deterred tax risk insurers from underwriting TP risks. This has changed in the last couple of years.

Many insurers are now more comfortable with TP risks, are supported by TP specialists, and have insured a number of TP risks (with a focus on financial instrument TP). Many other insurers are starting to venture into the TP insurance market. This development enables corporates to consider a new approach to their TP risks.

The development of TP documentation over the last few years has made many TP risks insurable. In such cases, the insured would transfer the risk of a TP adjustment by the tax authorities to the insurer. The insurance could typically cover not only the underlying increased tax liability, but also advance tax payments, interest, penalties, and defence costs.

The following are examples of TP risks, which are potentially insurable:

- Interest rates applied to financing and loans (in particular shareholder loans).
- Licencing fees.
- Relocation of intellectual property (IP).
- Compensation for routine corporate support/functions.

The cost of TP insurance is typically between 2% and 8% of the insurance limit, and, depending on the complexity of the matter, a policy can be incepted within two to four weeks. Both historical and future TP risks can potentially be covered.

THE ADVANTAGES OF TP INSURANCE*

- Eliminating or limiting TP risks.
- Avoidance of "deal-breakers" in a deal context.
- No need for indemnities or funds in escrow to cover TP risks in a deal context.
- An insurance solution within 14–20 working days.

*subject to policy limits and exclusions.

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Two potential insurance approaches have been developed by the insurance market in relation to TP risks: the "bottom up" approach, and the "catastrophic risk" approach (see Figure 1).

"Bottom up" Approach

Where a market-standard TP study determined a certain transfer price (for example, 100), the insurer would take on the risk that a tax authority may adjust the transfer price higher or lower (for example, 105 or 95), resulting in a higher tax charge for the insured.

In our experience, the "bottom up" approach is more appropriate for relatively simple TP risks, for example, interest on shareholder loans. For more complex TP risks (for which there are, for example, no or little solid market comparables) the "catastrophic risk" approach is more appropriate.

"Catastrophic Risk" Approach

In this case, the insurance will only respond when the adjustment of the transfer price exceeds a certain threshold. For example, if a market standard TP study determined a transfer price of 100, with a variation between 85 and 115, then the insurer will only cover an adjustment outside of the set parameters – for example, over 115, or under 85.

Insurance based on a "catastrophic risk" approach is typically cheaper, as the risk to the insurer is typically lower.

Sometimes a combination of both the "bottom up" and "catastrophic risk" approaches may be appropriate. An example would be where insurance cover is provided on the basis of a price adjustment over 100 ("bottom up" approach) or below 85 ("catastrophic risk" approach).

FIGURE 1 The bottom up and catastrophic risk approaches protect against TP risks in different ways.

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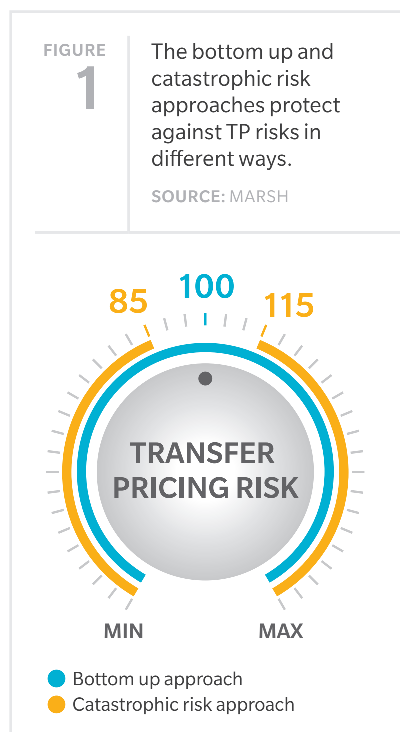

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