Business disruption: Transfer pricing issues and effects for the insurance industry

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In brief

Intercompany pricing can have a magnified impact on an insurance business' financial and tax position during times of severe disruption. Transfer pricing therefore should be an important consideration for insurance businesses in these times.

A combination of reduced liquidity, negative impacts on taxable income (e.g., through reduced investment income and increased claims), constrained workforce mobility, and increased volatility provides greater complexity for the insurance sector's tax departments. The effects of the current economic climate on insurance business activity, and therefore a company's tax position, are difficult to assess and can change quickly. At the same time, it is critical to structure responses that are flexible and geared toward both managing the current environment as well as the weeks and months ahead. When developing strategies to address this difficult environment and maintain consistent tax positions, businesses should take into account the transfer pricing considerations outlined below.

In detail

Capital rebalancing

Multinational companies, especially those that operate diverse lines of business, may find that certain jurisdictions require immediate capital infusion or other forms of capital support. These may be provided through internal arrangements such as guarantees, stop-loss or excess of loss reinsurance, surplus notes, and other forms of debt.

Observation: Such arrangements must be transfer-priced and documented under appropriate standards, taking into account current conditions. In addition, such arrangements may have significant tax and non-tax implications that should be evaluated, especially when comparing alternative ways to shore up capital where needed.

Reduced profitability

Many insurance businesses currently are, or in the near future may be, experiencing extraordinary costs and expenses from disruption, work stoppage, and other business interruptions associated with the current downturn in the economy. These extraordinary expenses, in combination with a general softening of the business outlook (e.g., margin erosion, reduced forecasts, depressed valuations, and lower investment income), could result in reduced US taxable income and potential negative tax consequences.

For example, insurance businesses that are experiencing reduced US taxable income because of a downturn in their business, but that still have base eroding deductions, may be more likely to have a BEAT liability.

To mitigate these impacts, there may be a need for an overall review of a company's operating model, including potential changes to:

- Flows and terms of services (e.g., workforce mobility, staff shortages, and trade)
- Timing of income and expenses (i.e., premium receipt and claims intake)
- Operating infrastructure and IP (beneficial) ownership and exploitation (e.g., information technology and data, new technology, business outlook, and reduced forecasts).

Observation: Transfer pricing may offer mechanisms and solutions (increase/reduce income) to adjust for these uncertain economic times in a manner consistent with the applicable standards, including identifying and addressing potential considerations with intercompany arrangements.

Liquidity

As access to cash has become more challenging, insurance businesses will continue to look at drawing cash from existing facilities and resources, internal and external, and to expand capacity and deploy cash where lines are down. This brings up significant questions tied to financial valuation, including market and instrument value, interest rates, cash pools, revolvers, and guarantees, many of which need to be immediately addressed.

Benefits, including potentially updated interest rates, can be explored with new evidence from the markets. All movements of assets/or cash can carry potential transfer pricing consequences that need to be evaluated and supported, or reconsidered given overall tax impact, including:

- New or revised intercompany arrangements to achieve cash redeployment objectives with consideration of loan modification rules for any revisions to terms; coordination with dividends
- Triggering of financial covenants and guarantees on both third-party and intercompany debt
- Credit rating assessment on updated financial projections for any ongoing work
- Prepayments and acceleration/deferral of payments (of financial instruments or other operating arrangements, e.g., services).

Reduced workforce mobility

Various jurisdictions may be considering or have imposed travel restrictions, resulting in an increasingly immobile/virtual workforce. This particularly may be affecting the insurance industry, in light of reliance on traveling underwriters and operating through a passporting regulatory structure. Furthermore, companies may have employees that cannot return to their home jurisdiction and are working abroad. Insurance businesses should consider whether such reduced workforce mobility might inadvertently create substance and permanent establishment issues that would increase tax liability and exposure.

Observation: The OECD issued recommendations to its members on April 4 on this issue, suggesting that tax authorities should treat tax consequences that arise from any dislocated workforce in a reasonable manner and consider the underlying circumstances that give rise to the issue. At the same time, specific country guidance has been limited, and it remains uncertain how the international tax community will respond to these circumstances.

The takeaway

In analyzing the potential implications noted above, comprehensive, real-time analysis is essential to inform tax, finance, and business decisions.

Let’s talk

For a deeper discussion of how this issue might affect your business, please contact:

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