

Insuring Tax Risk

The concept of insuring tax risks is not often considered, generally because of a lack of awareness. This article expands on the reference to tax insurance included in the article entitled 'Transaction Insurance and M&A Transactions' featured in the 22 December issue of *The Tax Journal* (Issue 962).

During due diligence of a potential acquisition, tax advisers for the bidder identified a \$150 million contingent tax risk which, if realised, would seriously impact on the value of the target. The sellers had taken expert advice from their advisers and whilst the risk was perceived to be extremely low, if not negligible, the investors and financiers of the buyer were unwilling to accept the contingent risk. The use of an escrow was not viable, as the quantum of tax exceeded 50% of the value of the target and could result in a large sum of money being tied up for five or six years and the sellers were unable to give an indemnity, as this would hamper their ability to distribute the proceeds, post sale. Given the scenario, the deal stalled.

Whilst relatively rare, these types of scenarios do occur and can prevent a deal from proceeding. Leading tax barristers may be asked to opine on the risk but the acceptance of such a risk by the buyer may still be too onerous for the buyer and/or its financiers to accept. In such a situation insurers have been willing to step into this space and provide a solution.

THE GROWTH OF TAX INSURANCE

The demand for specific tax insurance has largely stemmed from mergers and acquisitions, or other transactions where assets are transferred with tax planning structures. In the current market the potential to transfer a contingent risk off balance sheet could be critical to a restructuring strategy and/or to maximise value and return proceeds to shareholders/financiers or potential creditors.

Specific tax insurance policies have evolved over the last 10 years to cater for higher-quantum but low-likelihood tax exposures and provide cover for

Alena Watchorn, Executive Director of Willis Ltd, highlights the lack of awareness of tax insurance and asks whether it is a viable solution to mitigate large corporate tax risks

the actual tax quantum, as well as interest and costs incurred in evaluating, defending or mitigating a claim. Such coverage is particularly suited where other transaction mechanisms – such as escrows, indemnities or price reductions – are not commercially or financially viable.

Unlike the tax insurance facilities for smaller commercial exposures, which tend just to provide cover for the legal costs of a challenge, the bespoke

Degrouping relief

As part of a restructuring process and focus on core operations, it was decided to split the operations of a company into two separate entities. Steps were taken so that the demerger would be tax-neutral. However, the directors and financing banks were concerned that an unexpected challenge to the tax planning could potentially result in a significant tax exposure. This exposure impinged on the ability of the group to realise the benefits

During due diligence of a potential acquisition, tax advisers for the bidder identified a contingent tax risk which, if realised, would seriously impact on the value of the target

tax market is structured to transfer the whole potential loss.

Arranging such a specific policy is not just a case of completing a proposal form. Insurers who offer these policies need to understand the nature of the risk, what defences the target may have to a challenge and the quantum of the risk. Typically, therefore, rather than replicating the due diligence conducted by the client's adviser, the insurer needs to be given access to such due diligence on a non-reliance and hold-harmless basis. Insurers will seek their own advice and form their own view on whether or not to insure the risk.

CASE EXAMPLES

The below cases illustrate the nature and type of tax risks that have been insured but clearly each scenario has its own merits and features which insurers will consider when offering their capacity as security for the risk.

of the restructuring strategy, including the sale of one of the demerged entities and as such, tax insurance was sought. By doing this, the risk of a challenge to the applicability of degrouping relief under TCGA 1972, s179 was transferred to an insurer and the interested parties were able to benefit from the tax planning.

Inadvertent failure to make an election

During due diligence it was discovered that a target company had inadvertently failed to make a required tax election. The regulations of the relevant authority provided relief for such an error but the time frame for receiving this relief would prejudice the deal timetable. Further, if the election were denied, the target company could face a significant additional tax liability. Given that the risk of relief being denied was low and a delay to the transaction was not a viable option, tax insurance was arranged to insure the risk and enable the transaction to proceed.

Offshore tax risk

A buyer was acquiring a significant asset through a share sale but a risk was identified that the applicable tax authorities could challenge the offshore status of the corporate entity being acquired. Whilst all the due diligence conducted did not identify any basis on which a challenge could be made, the seller was unable to provide any further comfort, as it was financially distressed and needed to exit and distribute the proceeds to creditors. However, the buyer was uncomfortable with assuming the contingent tax risk, as it was only looking to acquire the asset. Given that an asset sale was unattractive to both parties, insurance was purchased to protect the buyer from the exposure.

The legal and professional costs and expenses incurred in defending or contesting a tax claim should be covered by the policy but these will not typically include the client's own management time, salary, benefits or expenses.

The trigger for a claim is often an enquiry by a tax authority relating to the insured tax treatment.

The insurer's financial exposure is limited by the policy limit. This should include provision for the need to gross up any claim (where a payment by insurers to the insured would be taxable) and interest relevant to the potential loss.

Policy periods are often six to seven years in duration. Policies are typically underwritten on a 'claims made' basis,

WHAT CONDITIONS ATTACH TO COVER?

Most insurance contracts are conditional on the actions of the insured and tax insurance similarly requires an insured to act prudently and continue to file its tax returns and computations within the relevant periods.

The insurer will want to be kept informed of any tax claim or enquiry but will not typically take over conduct of the claim, as it will recognise the benefit brought if the client and its advisers handle discussions with the relevant tax authority.

Nevertheless, as the insurer often bears the most significant financial exposure of the tax claim, it will want to ensure that it is consulted with and agrees to any settlement or defence procedure and, as such, the policy will typically include a provision for the mechanism of the claims process.

One of the tax-specific conditions required by the insurer is that if the insured realises a benefit, credit or payment which arises in respect of any payment to the insured for the covered tax as a result of an adverse determination, the insurer shall be entitled to reimbursement for such benefit so that the insured is in a neutral position and does not profit from the loss. Other conditions relate to assignment, confidentiality, authorisation and notification and how the premium and/or relevant arrangement fees will be paid.

WILL TAX INSURANCE BECOME MORE POPULAR?

Other transaction products, such as warranty insurance for sellers or buyers involved in M&A transactions, have taken some time to develop but have now become a more frequently recognised tool in M&A transactions.

Generally, once a client and its advisers have utilised these products, they recognise the benefits, yet are more cynical of their application when they have not had this first-hand experience. In the last 24 months tax insurance enquiries and policies arranged have increased significantly, which could be as a result of a perceived increased risk of a challenge, restructurings or a general awareness of the ability to insure.

In the current environment we believe there will be an increasing number of transactions where tax insurance will add value, particularly in the light of the need to cap any contingent liabilities which could impact on value.

In general, insurers are not willing to provide cover for transactions or planning which in their view could be considered overtly aggressive or abusive to the relevant tax authority

WHAT IS THE MARKET AND WHO IS INVOLVED?

Most leading insurers only accept business through insurance intermediaries. There are only three global insurance brokers which have teams which are focussed on providing transactional products of this nature, so it is important to work with one of these advisers, as they know and understand the risk appetite of the specialist insurers and can provide early-stage guidance on the likely coverage structure.

Similarly, there are only two or three insurers which lead the market. A large number of insurers will provide further capacity, which enables a potential exposure up to approximately \$200 million to be shared and placed within the insurance market. To ensure full access to this capacity, however, it is important to obtain a strong lead primary insurer which is recognised for its expertise in this area.

WHAT ARE THE FACTORS DETERMINING COVERAGE?

The key to the scope of coverage is the definition of the insured tax treatment. This definition sets out the tax exposure being insured. As such, a lot of focus is placed on this area and for this reason, typically there is close involvement of the tax advisers acting for both the insurer and the client in order to assess and define the exposure to be covered.

which effectively means that provided a valid claim is made during the period of the policy, there is no limitation (other than statutory time periods or contractual limitations) on how long it could take to reach a settlement or agreement.

Typical policy exclusions include fraudulent or dishonest conduct by the Insured, a change in the relevant tax legislation (except where such change is retrospective), or an inaccuracy or omission in the representation which the insured is required to provide to insurers on inception of the policy contract.

The representation referred to above requires the insured to declare that (having made enquiry of specific individuals) the insured is not aware of a pending enquiry or claim and that all material documentation relevant to the insured's tax treatment has been disclosed to the insurers and is complete and up to date. Any prudent client is best advised to ensure that its documentation for any transaction is retained and this is equally important to potential insurers.

In general, insurers are not willing to provide cover for transactions or planning which in their view could be considered overtly aggressive or abusive to the relevant tax authority. Neither are they willing to provide insurance for pre-packaged tax shelters and/or where there is no other commercial benefit.

Tax risks can be considered for cross-border and international jurisdictions and have been arranged in relation to tax issues arising in most of Western Europe, Australasia, South Africa and the US. In fact the US tax insurance market was quicker to establish itself than that in Europe.

Tax risks arising from non-domiciled ownership are a frequent source of tax insurance.

Companies worry if there is a question mark over the risk of there being a challenge to the offshore status of an entity and the tax consequences which may flow from this and the charges which may apply from offshore asset ownership, particularly on exit.

WHAT COULD YOU EXPECT TO PAY FOR TAX INSURANCE?

Given its specialist nature and the fact that the opportunity to mitigate or limit a tax loss may be limited and thus a partial loss unlikely, it is not the kind of insurance you can commoditise and sell at a low premium – tax risks of this nature are typically an ‘all or nothing’ scenario. So how do insurers rate these policies? In most cases, if



Alena Watchorn

the tax planning is aggressive and the likelihood of a challenge is 50:50, it is unlikely the typical insurance market will provide a solution. However, where the likelihood of a successful challenge is low and the merits are such that it is highly unlikely a claimant would succeed in winning a case (based on

prevailing case law at the time), the premium rates tend to vary between 3 and 8% of the limit bought.

For example, the \$150 million tax exposure referred to at the head of this paper represented 50% of the value of the target. A policy was arranged for a premium of \$4.5 million (3% of the limit), representing 1.5% of the overall deal value. This not only gave the buyer’s financiers the required comfort to proceed with the transaction but it was also more commercially attractive to the seller who, being a financial seller, was unable to provide an indemnity but was prepared to sacrifice 1.5% of the consideration to enable the deal to proceed.

Whilst still relatively small, the market is growing as clients become aware of the availability of this tool to transfer these risks and insurers themselves gain experience and capability to offer valuable and credible solutions.

Alena Watchorn may be contacted at Alena.watchorn@willis.com (tel: 0203 124 6310)

Interpret the latest legislation effortlessly

With the longest tax code in the world and several Rewrite Acts to come to terms with, interpreting the legislation is more difficult than ever, so having our reliable legislative guides and tax tables to hand is imperative. This set includes: the Yellow and Orange Tax handbooks – definitive consolidated legislation; the essential BDO Stoy Hayward companion volumes to the Yellow and Orange; and both the Budget edition and the Finance Act edition of our famous Whillans’s Tax Tables. This pack includes everything the practitioner needs to understand and use the latest legislation and tax rates.

Visit lexisnexis.co.uk/taxproducts for more information or to purchase your title today!

Pay £366.96 and save £91.74
OFFER EXPIRES April 2009

TOLLEY 2009
EVERYTHING YOU NEED FOR TAX



© LexisNexis 2009. 0109-003/JB/CE/0109

SOLUTIONS FOR KNOWLEDGE-DRIVEN PROFESSIONALS
Client Development | Research & Knowledge Solutions | Practice & Productivity Management | Risk & Compliance

