

The Tax Liability Insurance Market 2019

Brockwell Capital



Summary



The tax liability insurance (TLI) market continued to grow and evolve during 2019. The volume of requests for insurance increased both year-on-year and during the course of the year with cover being sought for a variety of risks across an ever broader range of jurisdictions.

This report aims to give an overview of how TLI was used in 2019 and offer some insights.

About us

Brockwell is a managing general agent which is appointed to source, underwrite, negotiate and execute insurance contracts on behalf of certain Lloyd's of London (Lloyd's) syndicates. Our tax team combines both legal and accounting expertise, together with excellent experience of providing transactional insurance solutions in a fund, private equity, financing, cross-border M&A and high-net-worth individual context.

During 2019, Brockwell offered terms of insurance for TLI risks in 18 different jurisdictions across a range of sectors and deployed more than £150m of risk capital.

Brockwell typically responds to requests for insurance within 48 hours and in 2019 we underwrote most of our TLI risks within two weeks. As well as meeting demanding timelines, we sought to offer innovative insurance solutions in order to enable clients to meet their commercial objectives. For example, although TLI is typically for historic risks, we created a forward-looking policy to cover a position on an ongoing basis that is subject to an annual renewal and in 2020 we will offer cover for transfer pricing.

We have authority to insure tax risks up to a limit of GBP 40m (or its local equivalent), EUR 45m or USD 50m with no minimum limit of liability in any jurisdiction other than the United States for a period of up to seven years. Brockwell is able to cover any tax and to insure both individuals and corporates.

As our risk capital is provided by Lloyd's syndicates, the credit underpinning our policies is rated A by AM Best or A+ by Standard and Poors and Fitch.

Further information about Brockwell's TLI offering is available on our [website](#).

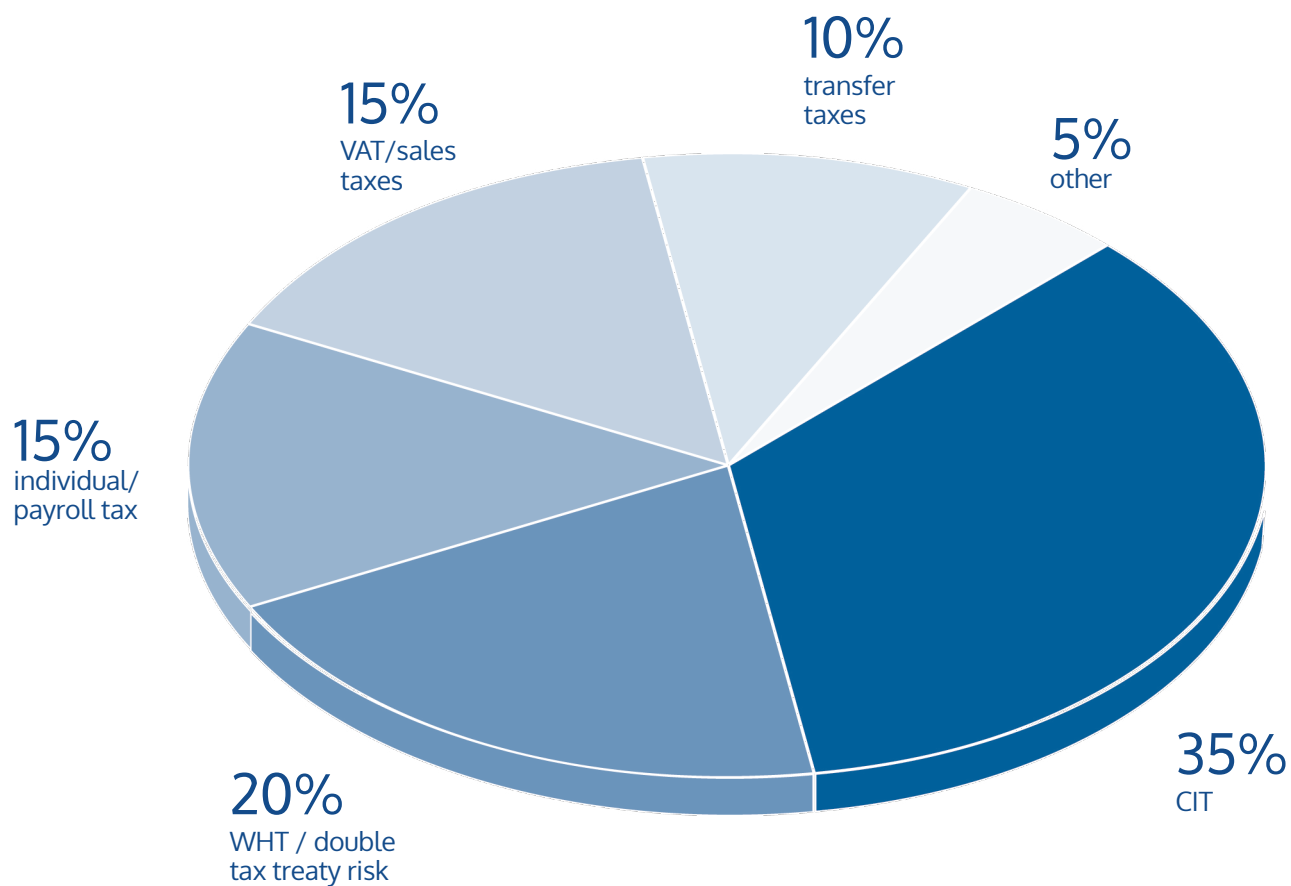
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What are taxpayers insuring?



Observations

The desire to insure CIT reflects the complex nature of corporate taxation, hence recourse to insurance for certainty.

CIT risks often relate to: (i) transaction-associated risks (but not just M&A), (ii) how an entity is classified for tax purposes (e.g. opaque or transparent), (iii) whether a receivable is capital or income in nature, or (iv) the availability of tax assets.

Substance-related risks or risks relating to NRCGT, in each case giving rise to withholding requirements, are also prevalent.

Why are taxpayers buying insurance?

TLI is overwhelmingly used to dispel uncertainty over interpretation of tax law. This can arise in a variety of contexts (e.g. wind-ups, reorganisations, M&A or ongoing risk management).

In a significant number of cases, TLI was sought to avoid capital being committed to an indemnity or escrow.

10% of requests for TLI related to high quantum risks where without TLI a transaction could not progress (e.g. risk relating to the migration of an entire business).

In Focus: Funds

More than 30% of requests for insurance received by Brockwell related to funds. We have highlighted below certain risk types, together with examples.

Fund Classification

It can be uncertain whether unregulated funds which benefit from a special tax status have failed to qualify for or might lose that status.

Example: An unregulated fund that is not liable for CIT may undertake activity which creates a concern that its CIT-exempt status has been prejudiced. It is possible to insure against the loss of the special tax status.

Wind-up

Once all investments have been disposed of, a fund might be holding back from returning funds to investors as a result of extant liabilities.

Example: A fund might have an outstanding liability pursuant to an indemnity or identified risk. It is possible to purchase insurance to cover the liability/risk and thus allow the fund to distribute proceeds.

Fund Withholding

Investors may be liable for tax as a result of the fund's activities (e.g. NRCGT), which the fund may be required to collect and account for.

Example: A fund may be required to withhold from a distribution depending on the nature of its investors. While the fund may have undertaken initial due diligence on investors, it may not have monitored this on an ongoing basis. Insurance could be purchased to mitigate the scenario where a distribution is made and then the tax authority asserts that the fund should have collected and accounted for tax.

Debt Funds - pricing

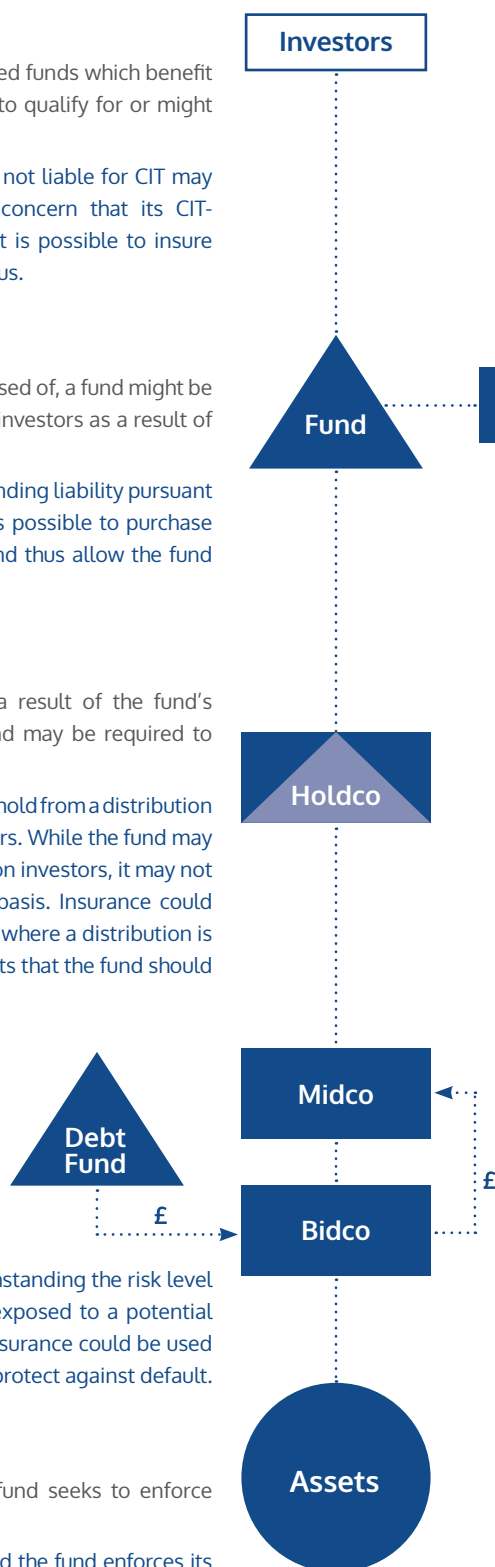
A tax risk may be identified which affects a fund's debt pricing.

Example: A borrower seeking acquisition finance may identify a tax risk during due diligence of such significant quantum that, notwithstanding the risk level is low, the fund is not willing to be exposed to a potential default where such risk crystallises. Insurance could be used to mitigate the identified tax risk and protect against default.

Debt Funds - default

Certain tax risks may arise when a fund seeks to enforce security on default.

Example: If a borrower is in default and the fund enforces its security there may be a risk of transfer taxes arising. Insurance could be sought to cover against any such transfer taxes.



Investment/Disposal

There may be a risk of taxation arising on a disposal or investment into a funds structure.

Example: A disposal of interests in an investment entity (e.g. a partnership) could give rise to a liability at exiting investor level (e.g. if the investment entity is treated as being a real estate rich company). In this scenario, certainty can be achieved by insuring the treatment of the exit.

Investment Manager

Investment Managers

Investment managers may encounter certain tax risks as a result of their co-investment or carried interest.

Example: It can be uncertain whether carried interest will be taxed as capital or income. It is possible to insure the position that carry will be taxed as capital.

Entity Classification

There can be uncertainty regarding the treatment of an entity within a fund structure.

Example: There may be uncertainty as to whether an entity is treated as transparent or opaque and, therefore, there could be a risk that tax arises within the structure. The entity's tax treatment could be insured.

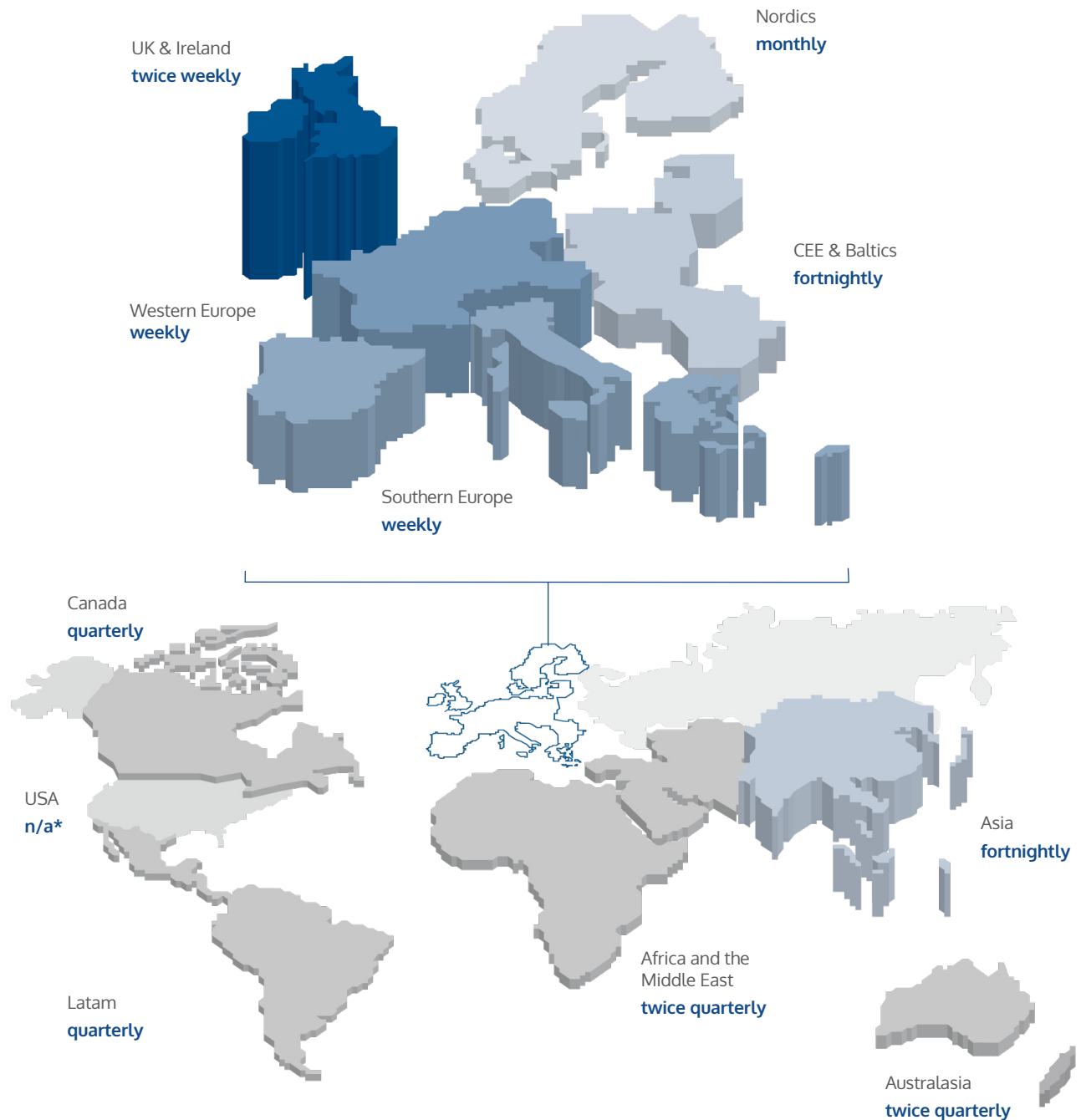
Structure/Modelling

A fund structure might contain a tax risk which, if it were to crystallise, would affect returns/modelling.

Example: There may be a withholding tax risk identified in respect of a cross-border payment of a dividend or interest within a fund structure. Insurance could be used to mitigate any such withholding tax.

Where is tax liability insurance being sought?

Key | jurisdiction
frequency of requests



Observations


Several requests for insurance have been driven by new legislation which lacks clarity/precedent/guidance, new case law creating uncertainty, or growing tax authority aggression.

With high transaction multiples, the need to protect modelling and, therefore, returns has led to a desire to insure.

Concerns regarding mandatory disclosure regimes (e.g. DAC6 in the EU) and exchanges of tax rulings/information has motivated taxpayers to seek protection against the increased risk of challenge.

* We do not currently offer TLI in respect of USA risks.

Motivations



There is a general perception that HMRC has become more challenging and is gathering more and more information about taxpayers. At the same time as deviating from guidance, refusing rulings and pushing for deliberate (instead of careless) penalties, HMRC is increasingly adopting technology in order to challenge taxpayers (e.g. HMRC Connect, the computer assisted audit tool, or the making tax digital initiative) and as a result of the mandatory disclosure regime and automatic exchange of information will have even more information about taxpayers.

Private equity firms, who regularly take out W&I insurance on M&A transactions, increasingly use TLI to derisk high quantum identified risks that would be excluded from a W&I policy (n.b. W&I only covers unknown risks). Private equity sponsors and their investment companies have become acquainted with TLI provided by UK insurers in an M&A context and this has translated into other corporate activity (e.g. reorganisations) or ongoing risk management (e.g. structural withholding tax). In 2019 a third of requests for TLI did not relate to M&A activity.

What is being insured?

TLI is most commonly sought in the UK to confirm whether (i) the conditions of the substantial shareholding are met, (ii) an asset is held for trading or investment purposes, (iii) contractors will be treated as employees, (iv) a targeted anti-avoidance rule is in point (e.g. the phoenix company rules), (v) a payroll liability exists pursuant to the employment-related securities legislation (e.g. does a company qualify for EMI), or (vi) SDLT is chargeable and on what amount. TLI is also often used as alternative to a ruling or clearance.

We expect further demand for TLI in respect of new areas of uncertainty (e.g. IR35 for the private sector) during 2020.

Predictions

The use of TLI in the UK will continue to spread to new sectors and contexts (e.g. derisking acquisition finance for a lender). Previously, risks overwhelmingly related to the real estate sector, but now real estate requests account for circa 50% with the healthcare and tech sectors making up a significant proportion. The average limit sought in 2019 was £8.7m, but managing for risks >£20m (which only make up 15% of requests) this dramatically falls to £4.2m and reflects how TLI is now used on much smaller risks.

As knowledge of TLI has spread and it has been used for smaller risks, there has been a noticeable increase in the number of high-net-worth individuals seeking insurance. During 2019 they accounted for a third of requests and we expect this to increase in 2020.

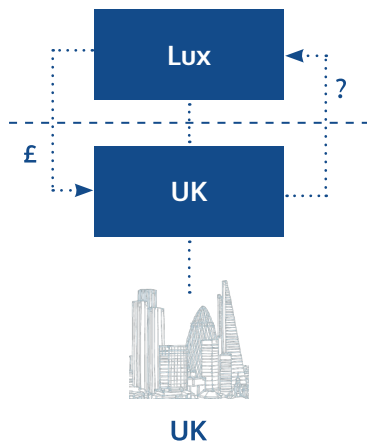
The number of requests for TLI in Ireland increased gradually throughout the course of 2019 with cover being particularly sought in a funds and real estate context. Unlike the UK, the average limit sought was £8.8m (removing risks >£20m), which suggests awareness of TLI can be improved. We expect demand to grow in 2020.

Brexit

It is difficult not to consider the impact of Brexit when looking to the future and as part of Brexit planning Lloyd's has established a Brussels vehicle so that syndicates can access the EEA market once the UK leaves the EU. The aftermath of Brexit may pose some interesting tax uncertainties. For example, based on Boris Johnson's current deal, Northern Ireland would remain subject to EU VAT law whilst the rest of the UK would not.

In the meantime, several UK TLI requests have related to transactions involving the migration of businesses outside of the UK.

New Development: Benchmarking Insurance



What is benchmarking insurance?

Brockwell's benchmarking insurance offers protection against losses suffered where the arm's length pricing of a transaction that is supported by a benchmarking study is challenged by a tax authority.

It is fundamental that a benchmarking study has been prepared and the purpose of benchmarking insurance is to support the pricing range proposed by a study. That is, benchmarking insurance cannot be used as an alternative to a benchmarking study, but it can offer commercial certainty alongside such a study.

If a tax authority asserts that the arm's length price is different to amounts paid or accrued, then benchmarking insurance will offer cover for tax arising as a result of the difference between the price charged and what is arm's length.

What will Brockwell insure?

In broad terms, the following hallmarks are indicative that we can offer benchmarking insurance:

- the relevant jurisdiction applies the OECD's transfer pricing guidelines and upholds the rule of law,
- it is clear why the benchmarking study has applied the chosen methodology and that methodology has been applied to an appropriate data set (and it is clear what data was discarded and why),
- the pricing range proposed by the benchmarking study is not wider than 6%,
- how the relevant transaction is priced is not especially subjective (e.g. intangibles),
- the transaction is not a vehicle for artificially extracting profits to a low (or no) tax jurisdiction, and
- insurance is not being sought as an alternative to typical prudent behaviour (e.g. instead of maintaining transfer pricing documentation).

Uses for benchmarking insurance

Ultimately, benchmarking insurance can be used to save time, offer certainty or as part of ongoing risk management.

In particular, transfer pricing arrangements can be insured in an M&A context in order to:

- provide a quicker (confidential) alternative to a tax authority clearance,
- remove the need for an escrow or reserve,
- stand behind or replace an indemnity, or
- mitigate a risk to allow for favourable financing terms.

What is required for a quote?

In order to consider offering terms for benchmarking insurance, as well as what cover is sought (e.g. limit of liability and policy period), we require:

- a copy of the relevant benchmarking study,
- details of the relevant transaction (e.g. how is it documented?), and
- confirmation of what transfer pricing documentation is available.