Brockwell

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The Tax Liability Insurance Market 2020

Brockwell Capital

Headlines

On average we received 8 requests for tax insurance every week

from more than 40 different jurisdictions

1/3 requests related to real estate

>50% related to institutional investments/investors

1/4 requests related to transactions other than M&A

Despite a challenging year for the global economy, the number of requests for tax insurance (RFIs) grew by almost 25% and usage has spread significantly. Even though the number of RFIs declined by 20% from Q1 to Q2, in each quarter we received more RFIs year-on-year.

As knowledge and usage of tax insurance has developed, we have received a wider range of RFIs. Requests relating to real estate declined from almost half to a third and a quarter of RFIs we received were not related to an M&A process. For example, reorganisations, restructurings, fund-level risks, ongoing disputes, or risks associated with business operations (e.g. VAT/sales tax treatment). However, we continued to predominantly receive RFIs relating to investments in private companies which is unsurprising given the pressure on asset managers to protect value.

It will be interesting to see how the tax market further develops in 2021.

About us

Brockwell is a specialty insurance provider that offers financial lines insurance, with a particular focus on covering international tax, W&I, and contingent risk. We offer clients the best features of a large insurance company – experience, global reach, financial cover up to £45m (or equivalent), and credit rating – in combination with the agility and flexibility of a smaller business.

Our tax team are experienced with underwriting complex international tax risks and includes international tax law and accounting experts. Our varied skill set allows us to assist clients with a broad range of risks, whilst our transactional focus means that we are very agile. We're very responsive – please see page 4 for details of our process.

Our clients and brokers come to us for a quick, clear, and reliable service without execution risk. We particularly specialise in providing tax insurance solutions for the private equity (PE) / investment industry, as well as for PE-backed management teams. We always engage external local advisers who are sector experts for the matter in hand, which means we offer a smooth, commercial process. We have global network of top-tier advisers which helps us provide a highly responsive service around the world.

Our tax book continued to grow in 2020 and we deployed 20% more risk capital than 2019, but 2020 was also an exciting year for Brockwell generally. We were pleased to add Convex to our risk capital providers, as well as welcoming Jai Patel as a Senior W&I Underwriter. For more information about Brockwell please visit our website.

To discuss further, please contact: Richard Taylor-Whiteway, Head of Tax
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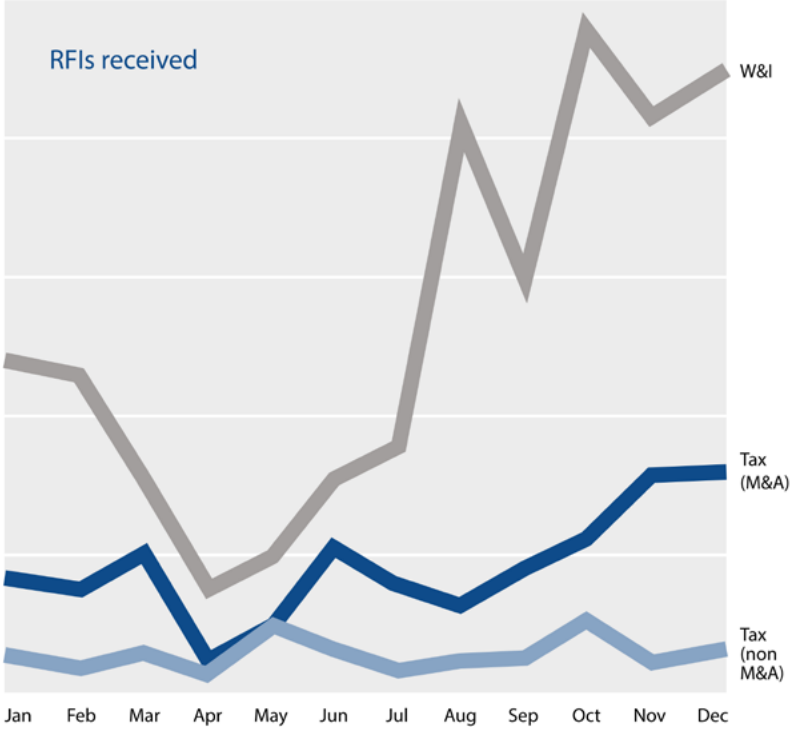
When was tax insurance sought?



This graph shows the volume of tax RFIs received each month compared to W&I (n.b. excluding the USA). RFIs relating to Tax (M&A) and W&I are a good indicator of global M&A activity and show 2020's market volatility. The graph also shows how demand for non-M&A tax insurance was broadly consistent throughout 2020.

Coronavirus

We expect increased demand for tax insurance as tax authorities respond to revenue collection pressure with governments looking to cut deficits created/increased by their responses to coronavirus.

As shown opposite, there was a material decrease in M&A activity during Q2 as worldwide lockdowns commenced. However, as shown there was not a sustained drop-off in non-M&A activity and we received regular RFIs relating to debt restructurings, reorganisations, business operational risk, etc.

As tax authorities became preoccupied administering job retention schemes and other covid-19 support, from Q2 onwards we noticed a dramatic increase in RFIs where the underlying motive for seeking insurance was to achieve the comfort of a tax authority clearance or ruling as fast as possible. Tax insurance was often proposed by advisers during 2020 in order to prevent an M&A transaction from stalling in a generally difficult transactional environment.

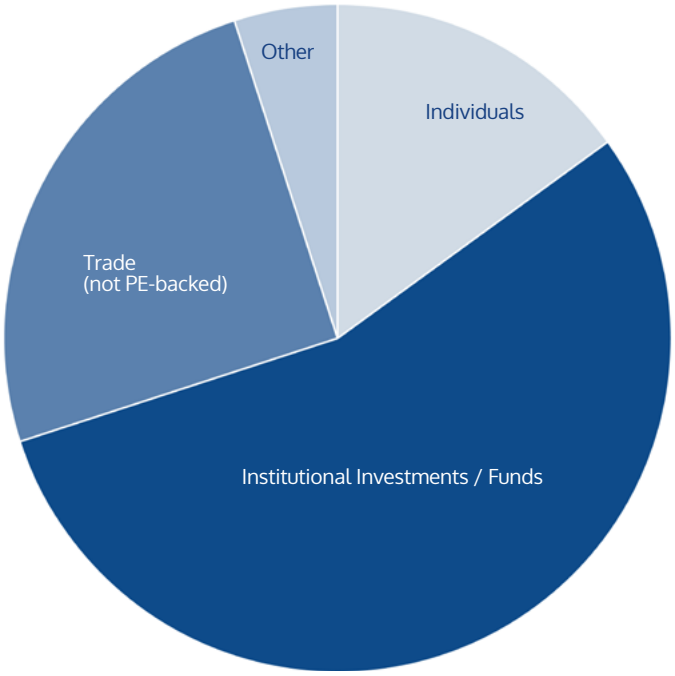
Who is seeking insurance?

The average financial cover sought (disregarding outliers >£50m) was circa £7.5m, with insurance sought for as little as £750k of cover and as much as £500m. RFIs for lower amounts of financial cover reflected increased tax insurance usage by individuals for personal tax matters (see opposite). Individuals typically sought cover in relation to equity arrangements or real estate transactions.

We regularly support private equity sponsors and PE-backed management teams. Feel free to contact us if you would like to discuss examples of how and when tax insurance can assist.

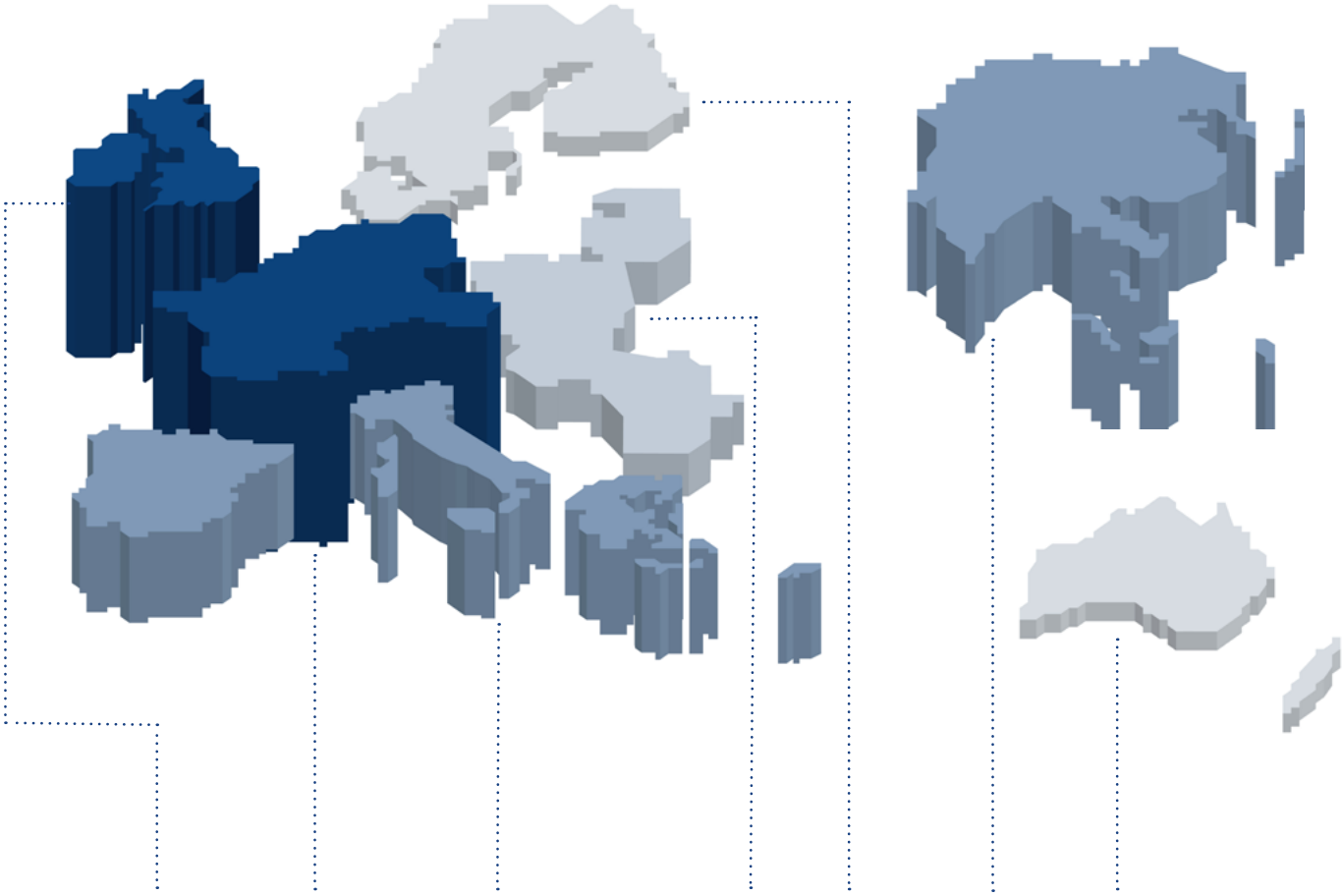
Common Sectors

A third of RFIs related to real estate investments with leakage from investment models being a key driver for seeking insurance (see examples of risks on page 5). The general growth in RFIs was underpinned by the energy and medical sectors – RFIs from both doubled. Similar to real estate, passive investors in renewable energy projects sought to protect returns on investment by using tax insurance. Robust M&A in the medical sector meant that tax risks were identified during the due diligence process, particularly in relation to whether payments to contractors are subject to payroll taxes or the VAT/sales tax treatment of supplies and services.



This pie chart shows the approximate split between persons seeking tax insurance.

Where is tax liability insurance being sought?



Approximate frequency:	UK & Ireland **twice weekly**	Western Europe **twice weekly**	Southern Europe **weekly**	CEE & Baltics **fortnightly**	Nordics **monthly**	Asia **weekly**	Australasia **monthly**

This heat map shows where most RFIs originate globally, together with the frequency of requests. It should be noted that the USA is not included because we do not offer insurance for USA tax risks, but it has a highly developed tax insurance market.

Whilst a large number of RFIs relate to the UK, with most risk capital coming from the London insurance market, there has been a noticeable increase in RFIs from other jurisdictions. Various insurance broking firms have hired tax expertise (e.g. in APAC) and awareness of tax insurance is growing which has led to more RFIs covering an increasingly diverse range of topics and jurisdictions. In particular, we saw a dramatic increase in RFIs from Western Europe.

Western European RFIs break down as Benelux (30%), Germany (40%), and France (30%), with RFIs from Benelux doubling since 2019. Luxembourg RFIs almost exclusively related to fund structures and Belgian RFIs mainly concerned real estate investments, but Dutch RFIs covered a range of sectors/scenarios demonstrating growing awareness of the flexibility of tax insurance.

Most Nordic RFIs are currently Danish, which is unsurprising given that SKAT is a challenging tax authority. Brockwell is very active in the Nordics from a W&I perspective and we continued to underwrite Nordic tax risk during 2020 particularly in relation to real estate. We expect Nordic tax insurance to be a growth area in 2021.

We also expect tax insurance to grow in APAC during 2021 and APAC RFIs came from a much wider range of jurisdictions in 2020. Asian RFIs shrank by 10% year-on-year, but this reflected a decrease in requests for Indian-Mauritius double tax treaty insurance presumably because fewer pre-April 2017 investments remain which are grandfathered (although >50% of Asian RFIs still related to India). We are very active in Australasia and expect an increase in RFIs due to the aggressive behaviour of the ATO.

How do I get a tax insurance quote?

Contact Your Insurance Broker

Send the following information to your tax insurance broker and ask them to contact Brockwell:

i. an outline/description of the tax risk,
ii. details and analysis of any facts relevant to the risk (both positive and negative),
iii. a calculation of the financial cover required,
iv. details of what insurance is required (e.g. who is the insured, policy period, how much financial cover, etc), and
v. copies of any tax advice in relation to the risk.

If you do not have a specialist tax insurance broker we would be happy to make a recommendation. Please contact submissions@brockwellcapital.com.

Submission Review

We will aim to revert with non-binding indicative terms of insurance (an NBI – see below) or a declinature within 48 hours of being contacted. Our ability to meet this turnaround time will depend on the complexity of the risk.

This service does not cost anything.

NBI

If we consider the risk to be insurable, we will provide an NBI which will include:

- Premium quotes for the financial cover requested.
  We charge a single, up-front premium which is payable once we have incepted the policy.
- Details of our fixed external costs.
  If appointed to underwrite, we would engage external counsel to assist us with our review. See 'Appointment' below.
- Details of our fixed external costs.
- Any key information/documents that we will require for underwriting.
- Any factual assumptions we have made for the purposes of offering terms and pricing the premium.

If we are unable to offer terms, we will give an explanation for our declinature. We understand that it is often important to know why insurance is not possible. For example, where an adviser has recommended considering insurance or this possibility has been mentioned to an investment committee / board.

Appointment

If you would like to proceed on the basis of our NBI then we will issue an expense agreement to be signed which covers our external costs (your insurance broker can liaise with us to arrange the expense agreement). We will commence underwriting once this document is signed.

Underwriting Processs

Typically, our underwriting process commences with a review of all relevant documentation, together with an initial Q&A process (your insurance broker will be able to liaise between any stakeholders). To the extent necessary, we would then circulate further Q&A based on our review of the information received to clarify any material outstanding items. Following this, we will finalise the policy terms.

Subject to the complexity of the cover sought, we can deliver a finalised policy within five business days of receipt of a signed expense agreement and all relevant documentation. If there is commercial pressure to achieve a certain deadline, it may be possible to meet an even more challenging timetable. Please ask.

Typical Costs

We price the premium as a percentage of the financial cover sought. Typically the percentage is between 2% and 8% depending on the nature of the risk and is subject to our minimum premium which varies according to the nature of the risk and the jurisdiction (please ask).

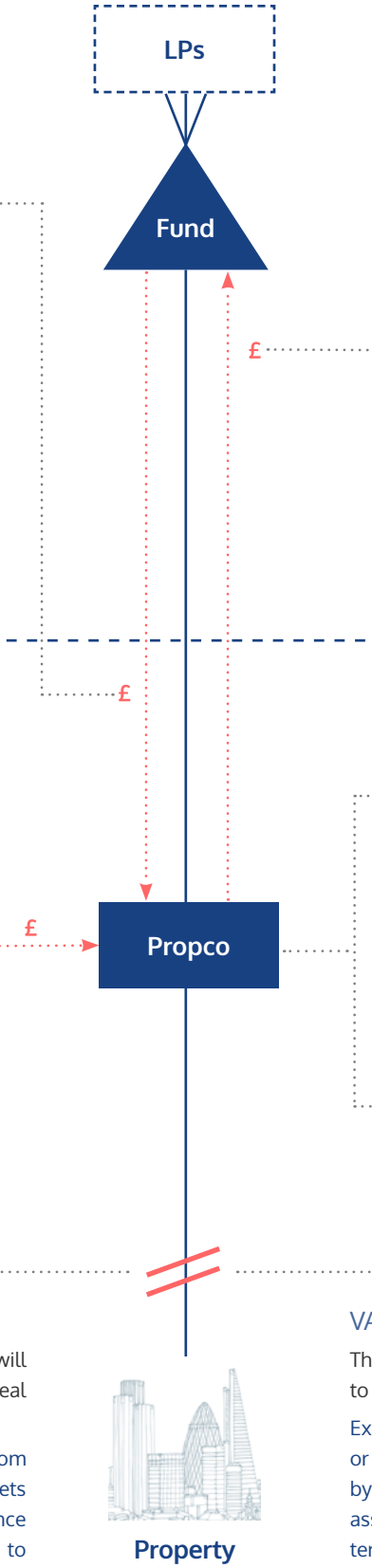
Our external expenses vary according to the complexity/size of the risk and the scope of work required and we will seek a quote from our advisers before providing our NBI so that the policyholder is aware of all costs up front. Typically, our external expenses are between £10,000 and £20,000 (or equivalent) but for an exceptionally straightforward matter they could be less.

Contact us

If you have any questions about Brockwell or otherwise, please contact us and we would be happy to help.
Richard Taylor-Whiteway (Head of Tax) can be reached on +44 (0)20 3923 9683 or at **richard.taylor@brockwellcapital.com.**

In Focus: Real Estate Investments

More than a third of RFIs we received during 2020 related to real estate assets.
Below are some of the risks that we are regularly asked to insure.



Interest Deductibility – shareholder debt

Taxpayers may want additional comfort that a transfer pricing adjustment will not be made on interest payable to a connected person thus leading to disallowed finance expenses.

Example: As a benchmarking study offers a limited degree of comfort in respect of transfer pricing, a borrower may enhance its position by obtaining insurance to guarantee the deductibility of interest. Insurance may be possible provided that an appropriately detailed transfer pricing report has been produced.

Interest Deductibility – external debt

The deductibility of third party finance may not be certain in all cases and can give rise to material liabilities.

Example: Where a third party lender requires a separate finco to draw down funds and this is subsequently merged into bidco, there may be concerns regarding interest deductibility where the bidco (which did not draw the debt) is the surviving company.

Transfer / Stamp Taxes

It is often unclear whether transfer taxes will apply or in what amount to an acquisition of real estate assets.

Example: It may be unclear whether a relief from tax applies to a transfer of real estate assets (or may be denied pursuant to anti-avoidance legislation). It is possible to use insurance to mitigate any risk in this respect.

Real Estate Rich Rules

It can be unclear when analysing capital gains or transfer taxes whether certain 'real estate asset' thresholds are met.

Example: The treatment of certain assets can be subject to interpretation. For example, do subterranean cables or equity interests constitute real estate assets? If we are provided with details of the relevant assets and which assets are (or are not) potentially real estate assets then we can consider cover.

Withholding Tax

Repatriation of income from a propco to an overseas shareholder may be subject to withholding on interest or dividends.

Example: If material sums are repatriated any unexpected leakage can affect investor returns. Provided sufficient information is available regarding the structure's purpose, residence, and substance it is possible to insure against this.

Residence

It can be subject to interpretation where an entity is resident and therefore subject to taxation.

Example: A propco may be incorporated in one jurisdiction, but a purchaser may have concerns that an overseas shareholder has affected the residence position of the propco. If we are provided with analysis in respect of board meetings, board composition, director CVs, etc then we can consider cover.

Trading or Passive Investment

Whether an entity holds assets for trading or passive investment purposes can affect its tax treatment.

Example: Where an unregulated fund is being wound-up to return proceeds to investors and is transferring its assets, a question can arise as to whether the sale constitutes a trade and thus affects the fund's special tax-exempt status.

VAT / Sales Tax

There may be a risk that a sale of a real estate asset is subject to VAT / sales tax with a substantial amount of tax at stake.

Example: It can require a judgment call as to whether an asset or an enterprise is transferring and certainty can be achieved by seeking insurance. A note applying the relevant law to the assets being purchased will assist with obtaining competitive terms.

M&A Insurance Experts

Aside from tax, we are experts in providing M&A insurance solutions. Our team which is led by Andrew Graham has more than 50 years of combined experience with transactional insurance products dating back to 2004. This market-leading expertise and our dedication to deal execution means that your M&A transaction is in safe hands with Brockwell.

Our experienced M&A professionals can fit seamlessly into a transaction to help get the deal done and our in-house tax and accounting experts allow us to provide a more agile service without reliance on external advisers.

If you would like more information about Brockwell's W&I and contingent liability insurance capabilities, please contact us at submissions@brockwellcapital.com.

On average we receive >50 requests to insure M&A transactions every week

cover up to £45m

global W&I appetite

mid-market PE specialists

broad sector appetite

in-house tax and accountancy expertise

In response to the unique pressures on business and dealmakers during 2020 we have created a "synthetic W&I product" to facilitate distressed deals.

Brockwell will propose a set of warranties we can insure and then undertake a Q&A process in order to get comfortable with those warranties. This quickly provides buyers and relevant third parties (e.g. finance providers) with more comfort.

Contact us for more information.