

## TAX LIABILITY INSURANCE

**Richard Taylor (Brockwell Capital) explains the features and benefits of tax liability insurance.**

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In an increasingly complex tax environment, tax liability insurance seeks to offer a simple, innovative, confidential and efficient solution for sophisticated issues by allowing a taxpayer to reduce or eliminate a tax exposure.

The purpose of tax liability insurance is to protect against differing interpretations of tax law. In essence, it is a tool that provides tax treatment certainty in order to facilitate activities by both corporates and individuals or alternatively to assist boards, investment committees, asset managers, finance providers, etc with managing risk. While tax liability insurance has been available for several years, in the last 18 months there has been a significant increase in the number of transactional risks which have been insured. This is due to a number of factors, including an increase in the number of underwriters and insurance brokers with tax expertise, as well as more available capacity in the market leading to higher limits being offered on certain risks. Further, the maturing market and greater expertise of underwriters has led to increased jurisdictional appetite, meaning that more tax risks can be insured.

In a mergers and acquisitions (M&A) context, warranty and indemnity (W&I) insurance has become commonplace. However, unlike a typical W&I insurance policy, tax liability insurance covers identified risks and can offer a solution in a multitude of scenarios (e.g. reorganisations, asset purchases, liquidations or mitigation of historic risks). Covered losses can include the tax suffered, defence costs, interest, penalties and grossing-up to take account of tax borne on the insurance proceeds.

Each tax policy is bespoke to the risk in hand and, depending on the risk profile, the insurance premium is typically between 2% and 8% of the limit of liability insured. The premium is a single, up-front payment made at inception of the policy.

### When can tax liability insurance help?

Ultimately, tax liability insurance offers a new way to manage risk, can provide the certainty required to allow a transaction to progress or, importantly, saves time. In particular, tax liability insurance can be used to:

- give peace of mind in relation to a historic tax position;
- remove the need for an escrow or reserve;
- stand behind or replace an indemnity;
- prevent price negotiations or delays by mitigating identified risks;
- allow investment funds to be liquidated and proceeds returned to investors;
- provide a liquidator with the comfort required to release proceeds;
- remove uncertainty from a restructuring or reorganisation;
- mitigate a risk to allow for favourable financing terms;

- provide a greater limit of liability than a counterparty is willing or able to offer (e.g. the insurance sits in excess);
- secure catastrophe cover (e.g. where a tax liability, no matter how remote, is unconscionable);
- increase covenant strength and manage recoverability risk (Lloyd's syndicates are all rated A by AM Best or A+ by Standard and Poor's and Fitch);
- reduce uncertain accounting tax positions or tax expenses; or
- provide a quicker and confidential alternative to a tax authority clearance (or provide the comfort of a clearance if this is not available).

### What can be covered?

Tax liability insurance can cover any type of tax in any jurisdiction, with limits of liability ranging from as little as a million up to hundreds of millions of dollars. It is possible to obtain insurance protection for both corporates and individuals. Since each insurer will have differing appetites and maximum limits of liability, a broker can assist with selecting an insurer.

Among other factors, insurability depends on:

- the likelihood of a challenge by a tax authority (the risk should be considered low);
- the defensibility of the position taken (there should be defences available and the appropriate documentation/evidence should be available);
- the fact pattern relating to the risk (insurers will rely on the facts as represented to them – see below);
- the situs of the risk (the relevant jurisdiction should have a stable court system with a concept of legal certainty);
- the quantum of the liability; and
- the motivation for insurance.

Although tax liability insurance will not offer protection against any divergence from the facts presented to the insurer, it is possible to insure whether a legal test is met on the facts as represented.

Tax liability insurance is not available for intentional tax avoidance/evasion or marketed schemes.

### Who pays for the insurance?

Where tax liability insurance arises in an M&A context, it is usually a matter of negotiation as to which party bears the cost of the insurance.

Where a seller (i) is not willing to offer comprehensive tax protection, (ii) is willing to offer tax protection but has weak covenant strength, or (iii) will wind-up post-closing and distribute proceeds (e.g. in a fund context), then the buyer will often pay for the tax liability insurance, but require that the seller provides the relevant information to permit the insurer's due diligence.

## Tax liability insurance in practice

Below are a few examples that illustrate the varied creative and strategic uses of tax liability insurance.

- A private equity bidder in a competitive auction process identified a tax risk during due diligence. Instead of reducing their bid or proposing an indemnity/escrow, the bidder proposed insurance to be paid for by the seller.
- A fund had given certain indemnities as part of historic M&A activity. Insurance was purchased to allow the fund to be wound-up and proceeds returned to investors.
- A real estate investor was preparing an asset for sale when a historic structural tax liability was identified. To protect the investor's clean exit and preserve the asset's value, an insurance policy was obtained and included in the data room.
- A family office had identified a risk relating to the acquisition of a real estate asset, but was unwilling to rely on the covenant strength of the individual seller. With an insurer providing cover, a sufficient level of comfort was achieved such that the transaction could progress.
- A buyer had acquired a business with a known tax risk. Post-acquisition, the buyer obtained an insurance policy to prevent a tax provision for the risk in their accounts that might, for example, affect the buyer's future financing position.
- A lender providing acquisition finance identified a risk that had not be dealt with as part of the transaction. Due to the quantum of the risk, an insurance solution was sought to prevent cash leakage from the borrower's post-acquisition group.

Tax liability insurance is very flexible and can be tailored to respond to new situations as they arise or as legislation changes.

## Basic Policy Terms

Each tax liability insurance policy is bespoke to the precise risk in hand, but below are the key provisions that are common to each tax liability insurance policy.

- **Insured tax event** – The definition or clause setting out the insured tax event is tailored to the specific risk for which cover is sought and the insuring clause will cross-refer to this.
- **Excess** – The excess, also known as the 'retention', depending on the risk in hand will often be in respect of defence costs only in order to ensure that the insured has 'skin-in-the-game'. Alternatively, the excess can be structured such that the insurer is covering a catastrophe scenario in excess of existing protections that the insured has available.
- **Exclusions** – Each policy will be subject to general exclusions, such as (i) change in law (however, where the insured risk relates to change of law then this can be adjusted accordingly), (ii) inaccurate representation in the representation letter (see below) or non-disclosure in a claim notice, (iii) failure to following proper filing procedures in respect of the insured risk or, where relevant, divergence from the underlying transaction steps (e.g. in respect of a reorganisation), (iv) deliberate non-compliance with conduct obligations (see below), or (v) fraud.
- **Representation Letter** – The insurer will require a representation letter stating that the information provided during the insurer's due diligence process is true, correct and up-to-date and that the insured is not aware of any other information that would reasonably be relevant to the insurer's

review of the risk (where relevant, having made due and careful enquiry of certain parties). The insurer may also require representations in relation to specific facts or circumstances which have arisen during the course of underwriting.

- **Conduct** – These provisions are intended to avoid the insurer being prejudiced by the actions of the insured. For example, by ensuring that the insured does not act in a way to provoke the relevant tax authority or engage with the tax authority regarding the insured risk without discussing with the insurer first.
- **Deliverables** – Certain deliverables will be a condition to cover. These include, delivery of the signed representation letter (see above) at the commencement of the policy, payment of the premium and other key items.

### Factors to consider when seeking insurance

When advising a client in respect of tax liability insurance, it is important to consider:

- what the limit of liability will comprise (i.e. calculating the tax risk, defence costs, penalties, interest and/or gross-up for which cover is sought);
- what is the relevant statute of limitations and, therefore, the desired policy period;
- who is to be the insured (e.g. where parties are jointly and severally liable, it may be simplest for one party to give a cross-indemnity to the others that is then backed by insurance);
- what documentation is (and is not) available for the insurers to review as part of their due diligence (to the extent that key information is unavailable, the insurer may require a representation in respect of such); and
- who has the relevant knowledge to provide information as part of the underwriting process (to ensure the best coverage position it is key to be able to support the insurer's due diligence process).

It is also helpful to approach insurers with a memorandum of advice prepared by one of the insured's professional tax advisors containing details of the risk for which cover is sought. This should be supplied with details of the pertinent facts and an overall view on the likelihood of challenge by the relevant tax authority as well as the likelihood of any such challenge being successful.

Further, it should be borne in mind that the insurer will need to have certain participation rights in respect of any enquiry or assessment by the relevant tax authority (see above). For example, where a party is seeking tax liability insurance to sit behind an indemnity they are giving, it will be necessary for the indemnifying party to retain conduct of claims.

### What is the typical underwriting process?

Once a risk has been identified then an insurer can be approached with a request for insurance setting out details of the risk, which should include:

- if relevant, an outline of the underlying transaction (e.g. timeline, parties, advisers);
- details of the tax issue (e.g. background facts, description of the risk, jurisdiction, available defences); and
- coverage requirements (e.g. who is the insured, limit of liability, policy period, any specific requirements).

If the insurer then deems the risk to be insurable they will offer indicative non-binding terms for the insured to consider. While insurers are able to offer terms in two working days, subject to extraneous time pressures it is often best to allow a working week in order to ensure that insurers have time to offer their most competitive terms.

If an insurer is then approached to proceed with underwriting a risk, an expense agreement will be entered into between the insurer and the insured to cover any underwriting expenses. Expenses are non-refundable and will vary depending on the size and complexity of the risk, but are typically between USD 15,000 and 40,000. Once the expense agreement has been signed, the insurer will commence their due diligence process. This will typically consist of a review of documentation requested by the insurer at the outset and, if necessary, the insurer will then circulate written questions to elicit further information. The insurer may also hold an underwriting call to clarify any material issues arising from their review.

Subject to the complexity of the risk, the whole process can be completed within five business days from selection and receipt of all relevant documentation. However, in practice the process typically takes two or three weeks unless information is readily available to share with the insurer.

### **What is the claims process?**

Where a policyholder discovers a claim, in accordance with the terms of the policy the insurer should be contacted and details of all relevant and known information provided. Upon receipt of such, the insurer will acknowledge the claim.

The insurer will then agree a strategy with policyholder and any urgent items will be dealt with (e.g. appointment of advisers). Afterwards, the insurer will work with the policyholder to progress the claim until a settlement is reached, at which point the insurer will advance funds to the policyholder for them to settle the tax matter.

### **Looking to the future**

As there are more market entrants and awareness of tax liability insurance grows, the product will likely be used in more creative scenarios and to cover new risks. For example, certain insurers now offer a product to manage transfer pricing risk.

In the current tax climate, which is more and more challenging and complex for clients, insurance will be increasingly turned to as a solution.

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