

Uncertainty and risk

Richard Taylor-Whiteway believes that new trends in transactional insurance cover can be indicative of the problems caused by the coronavirus.

Tax insurance provides an insight into taxpayer sentiment – what concerns taxpayers, what activities are they undertaking and what will they do next? For example, concerns may relate to a particular subjectivity in the law: does a ‘business’ exist for the purposes of the *Ramsay v IRC* [2013] STC 1764 case? Is a liquidation caught by the ‘phoenix companies’ targeted anti-avoidance rule (TAAR)?

With Brexit on the horizon and various challenging tax changes coming into force – IR35 for the private sector and the latest EU directive on administrative co-operation (DAC6) spring to mind – 2020 was always going to be an interesting year. In the first month or so, the outlook was positive and it seemed reasonable to anticipate another year of buzzing corporate activity. Many requests for warranty and indemnity (W&I) and tax insurance were being made reflecting readily available capital and strong global mergers and acquisitions (M&A) activity, particularly in the UK and the Netherlands. W&I policies protect parties against a breach of contractual protections given in a sale and purchase agreement (SPA), while tax insurance offers cover for a specific identified tax risk.

Fast forward and the economic climate is now somewhat different. Global transactional activity has been disturbed and, among other things, uncertain valuations are making it difficult to deploy capital and obtain finance. This has led to a shift in what the insurance market is being asked to cover.

Uncertainty and risk appetite

Unsurprisingly, there has been a general reset of risk appetite. Asset managers, financial institutions and corporates are taking a more cautious approach than they might otherwise because of the risk posed to investors or shareholders by the current conditions. It is particularly unhelpful that rulings and clearances are difficult and slow to obtain. There are three clear trends as a result.

First, insurance is being sought for a wider range of (often more novel) risks. For example, a founding management team



that has exited their business may be concerned that the rate of capital gains tax will change, perhaps as some fear at the autumn statement, and so might seek to mitigate an upward rate adjustment. Equally, asset managers now faced with reduced returns who have modelled an investment based on the use of specific tax assets are naturally keen to protect the availability of those assets to shield income – such as whether capital expenditure qualifies for capital allowances treatment and for which pool.

Second, individuals as well as corporates are seeking to insure W&I and tax risks. Individual fund managers have taken advantage of the pause in M&A to consider their personal tax risks, with cover to guarantee capital treatment regularly being sought in respect of carried interest arrangements. On the other hand, individual sellers are increasingly seeking to protect their position post-transaction with W&I cover to remove or limit their financial exposure under the contractual protections they have given. For example, a buyer of a business affected by the downturn might look to recover value from the sellers under the SPA (W&I claims are common in relation to non-performing assets).

Third, global economic activity is now occurring in different places, at different speeds, and in different sectors. Take the effect of lockdowns – although at the time of writing UK M&A activity has been somewhat depressed, the Australian and German markets have been robust which, to an extent, correlates to how and when these jurisdictions locked down. *Taxation* readers may also be familiar with the current stop/start nature of even simple UK transactions.

Key points

- Transactional activity has been disrupted by the coronavirus pandemic.
- Insurance is being sought for more unusual tax risks.
- Uncertainty from delays to tax rulings and clearances.
- Risks may arise in distressed mergers and acquisitions.
- Potential issues with corporate restructurings.

Tax authority capacity

Tax authorities have been overwhelmed responding to the coronavirus and the associated administrative burden. Large numbers of staff have rightly been redeployed to deal with their government's response, which has led to a delay in responses to tax rulings and clearances.

It is commonplace for a transactions in securities clearance to be sought by management for a management buy-out (MBO),

but in the current climate HMRC is unable to respond within the transaction timeline a private equity sponsor requires. As a result, management are seeking alternative protection, especially if a clearance has been sought and a response is outstanding at completion of the transaction.

Understandably, HMRC and other tax authorities have struggled for capacity and in a contentious context this has led to the issue of 'sensitivity letters', suspending ongoing enquiry processes, and a general delay in ongoing tax disputes. As a result, many taxpayers have sought cover for positions that are being investigated or audited to prevent the need to reserve for an assessment (or for ongoing tax litigation). It is also unclear how a pause in an enquiry will affect the late payment interest position, so it can be attractive for taxpayers to try to obtain financial protection for this to limit liability.

Distressed mergers and acquisitions

Unfortunately, a growing number of requests for insurance relate to distressed situations. This manifests as opportunistic M&A, as well as in relation to debt arrangements (see below).

Typically, the purpose behind insurance in a distressed M&A scenario is to protect the lender's position or provide additional comfort for a buyer. Senior creditors driving a pre-packaged administration can remove a historic risk that might prejudice a sale or mitigate a structural risk relating to the pre-pack. A group may have little ongoing trading activity and the lender-side tax advisers might, say, identify a risk that the substantial shareholding exemption could be unavailable – will HMRC agree that the subsidiary exemption is met? Equally, a buyer might want comfort that there has not been – or, if it behaves in a certain way, will not be – a major change in the nature or conduct of the trade such that trading losses are not available, particularly because such losses may be substantial.

Previously, buyers have taken on the risk of unidentified historic liabilities as part of distressed M&A. However, it is now possible for buyers in a such a scenario to obtain 'synthetic W&I insurance'. In short, the insurer proposes a set of warranties and undertakes a question and answer process to become comfortable when standing behind these contractual protections. The process is designed to accommodate limited due diligence and restricted seller involvement, while providing a buyer with additional comfort.

Restructurings and debt arrangements

There has been a dramatic rise in corporate restructurings and changes to debt arrangements – some to tidy a structure and reduce costs, but mainly driven by finance parties.

Corporate restructurings can produce complex problems. The parent of a distressed subsidiary may need to waive an inter-company balance, but how has this been accounted for? If the financial statements show a capital contribution, is there a risk that this might be considered to be taxable trading income?

Businesses finding themselves in difficulty may be forced to restructure their debt arrangements and taxpayers regularly encounter difficulties in relation to waivers, modifications, and debt-for-equity swaps.

For example, will a (deemed) release of an external debt or a modification give rise to a taxable credit? The corporate rescue provisions may apply if it can be reasonably assumed that, but for the release or modification and the surrounding arrangements, the borrower would be unable to pay its debts in the next 12 months. But what is 'significant financial distress' with a 'real prospect' of insolvency for the purposes of HMRC's *Corporate Finance Manual* at CFM33192 and CFM33194? What if the business makes a remarkable recovery which casts doubt on the forecast that it would not be able to pay its debts? This can be hard to judge and the sums at stake can be material.

A taxable credit might also be brought into account as a result of a debt-for-equity swap. If the capitalisation leads to a change in ownership or control of the borrower, this could give rise to a deemed taxable release of the debt under CTA 2009, s 362. The *Corporate Finance Manual* at CFM35120 states that such a taxable release may arise if unconnected lenders that do not individually control the borrower gain aggregated control. Again, the corporate rescue provisions can prevent a taxable profit arising, but it requires a significant judgment call.

What next?

It is a cliché, but we can expect the unexpected throughout the rest of 2020 and beyond. It is hard to say how the coronavirus pandemic will progress and what the effect will be.

That said, it is widely expected that revenue collection and enforcement is going to be a priority to fund the various generous coronavirus stimulus packages. Naturally, this is going to affect positions that have been insured – either directly in tax policies or indirectly through W&I policies – and a rise in claims notifications is likely.

At the same time, private equity funds currently have more 'dry powder' at their disposal than ever before with about 20% of assets under management yet to be deployed. To avoid losing investors, it might be expected that as soon as sufficient stability is achieved these funds will be looking to invest. This could lead to a flurry of transactional activity, but the question on everyone's lips is 'when?' ●

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Planning point

Tax insurance can be useful in corporate restructurings to provide cover for identified risks such as those relating to the tax and accountancy treatment of inter-company balance waivers or capital contributions.

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- Accurate drafting of tax warranties and indemnities: tinyurl.com/yazx6guw
- Tax planning steps for company sale: tinyurl.com/yct3t9o6
- The importance of a bespoke tax schedule in the purchase or sale of a business: tinyurl.com/yc4qumrn