

Tax Insurance has a long history, making its debut in the U.S. in the late 90s as part of the introduction of other transactional liability coverages such as Representations & Warranties. While R&W enjoyed explosive growth through the last decade's robust M&A market, tax took longer to establish its foothold. Ultimately, the use of tax insurance to support renewable energy transactions increased its popularity, with billions of dollars in tax limits deployed in support of renewable transactions. Today, it is an established market with over 20 carriers providing coverage with an estimated \$1 billion in capacity available for any single transaction.

Very simply, tax coverage provides protection to taxpayers (i.e., the Named Insured) should a tax position fail to qualify for its intended tax treatment. Coverage is available for corporations, trusts, partnerships, and, increasingly, individuals. Historically, coverage was mainly utilized in the context of "one-off" corporate issues; however, the market has now matured to cover a broader array of risks associated with ongoing tax audits and controversies; ensuring the accuracy of a corporation's ongoing tax returns; and, in the context of personal tax planning. The coverage provides certainty to planned tax consequences. This is a powerful tool every taxpayer should consider.



Tax Liability Insurance | A Growing Market

Tax Liability Insurance protects private equity firms, strategic investors, or other entities or individuals should a tax position fail to qualify for its intended tax treatment.

The Process

Insurance markets underwrite tax risks by reviewing an outside advisers' analysis of the applicable tax law and hiring their own tax counsel to opine on the risk. While a tax opinion is not required, a write-up of the facts, issue(s), analysis, and conclusion is necessary. The outside advisers' conclusion should be at a "more likely than not" comfort level. Underwriters engage in a time-tested process of reviewing the risk and compete on the one-time, upfront premium charged to insure the financial downside of an unlikely outcome.

Vanbridge acts as the gateway to insurance markets by connecting taxpayers and their advisers with insurance carriers. Vanbridge has the capacity to solicit competitive terms and pricing within a week or less, with underwriting and binding coverage often occurring within an additional week (i.e., a 10 to 14-day process).

Key Takeaways:

- ❖ The policy provides protection for the Covered Tax Position (i.e., the tax loss trigger) and contains exclusions for fraud, inconsistent filings, material misstatements, and changes in law.
- ❖ The policy covers additional taxes, interest, penalties, contest/defense costs and gross-up (income tax on the insurance proceeds).
- ❖ Premiums range between 2% and 5% of the total limits purchased (i.e., 2 to 5 cents on the dollar of coverage).
- ❖ Policy period up to 7 years to cover the applicable SOL (10 years available for specific risks).
- ❖ Insurance policies can be structured in amounts as low as \$5 million up to \$1 billion.
- ❖ Retentions (i.e., deductibles) vary by risk, including no retention policies or retentions applicable only to defense costs.

Types of Coverage

Provided that a transaction is not abusive or reportable under Treasury Reg 1.6011-4 (i.e., listed or confidential transactions, transactions with contractual protections), tax insurance is generally available where there is a sound basis in the facts and the law for the covered tax position. Examples include:

1. Renewable Tax Credits:

- a. For tax equity investors seeking to ensure that tax credits are respected (i.e., ITCs, PTCs, Section 45Q Carbon Sequestration, low-income credits, R&D).
- b. For developers seeking to ensure transferability of tax credits under Section 6418 of the Inflation Reduction Act.

2. M&A & Extraordinary Transactions:

- a. **Identified Tax Risks** – For tax issues identified during diligence (which are otherwise excluded from a Representation and Warranty policy), including usability of NOLs/tax attributes, executive/deferred compensation, tax consequences of prior restructurings, and transfer pricing risks.
 - i. **S-Corporation Qualification** – Validity of S-Corp status (i.e., ineligible SHs, disproportionate distributions, second class of stock, & late S Corp election).
- b. **Tax Structuring** – Ensure the intended tax treatment of the transaction structure, such as the validity of Section 338 elections, tax-free treatment to transactions under Section 351 transfers, Section 355 spin-offs, and Section 368 reorganizations.

3. Tax Audit/Controversy Insurance:

- a. For taxpayers seeking coverage for a tax issue already under audit with a taxing authority (i.e., federal, state, local, or foreign).
 - i. **Timing** – Insurance can be explored as soon as the taxing authorities dispatch an IDR requesting further information from the taxpayer.

4. Other Insurable Tax Matters:

- a. For taxpayers seeking certainty on a tax issue at a “more likely than not” comfort level.
 - i. **International Tax Risks** – Transfer pricing, foreign tax credits, U.S. trade or business, U.S. branch issues, U.S. sourced income, permanent establishment & FDAP implications, including cross-border issues.
 - ii. **Tax Risks Associated with Investment Funds** – Tax issues related to entering, structuring, or exiting funds, including activity in foreign jurisdictions/cross-border transactions.
 - iii. **Trust/Estate Planning** – Personal tax planning.
 - iv. **Tax Return Insurance** – Tax insurance on the entirety of the tax return for partnerships or corporations.
 - v. **REIT Status** – Including whether REIT status has been maintained.
 - vi. **Consolidated Return Tax Risks** – Including liability of former members under Treas. Reg. 1.1502-6.
 - vii. **Tax Reserves for Uncertain Tax Positions** – Tax insurance can impact FIN 48 reserves and balance sheets positively where uncertain tax positions have been recognized.

Why Tax Insurance is the Best Alternative

In short, tax insurance is a better solution than traditional methods used to tackle tax risk. In the context of extraordinary transactions such as M&A, recapitalizations, etc., the coverage allows parties to move forward with transactions by eliminating obstacles to closing. It is a more efficient use of capital over escrows or indemnities that restrict and tie up access to cash – particularly critical in today's constricted debt market. The underwriting process is faster and provides more certainty over the Private Letter Ruling process.

In addition, tax insurance provides an additional layer of review on a given tax treatment, offering much needed certainty in a complex regime of laws, regulations and guidance while ensuring that a taxpayer remains within the confines of supportable tax planning.

Most important, however, the coverage allows parties to focus their time, energy and resources on the things that matter most: closing transactions, running businesses without undue distractions, and maximizing the use of capital on their balance sheets.

For more information on how to integrate this coverage into your next transaction, please contact:

Nancy Rodrigues
Managing Principal
Vanbridge

C: 917.733.3293
E. nrodrigues@vanbridge.com

