



## Overview

Tax Liability Insurance provides protection to private equity firms, strategic investors, or any other entities or individuals should a tax position fail to qualify for its intended tax treatment. Tax Liability Insurance is often utilized within the M&A context (i.e., when a known tax risk is identified in diligence, or the transaction is structured to achieve specific tax treatment) or to minimize risks arising from general tax planning. Tax insurance transfers the financial risk to a third party (i.e., an A-rated insurance company for a premium) and protects the insured in the event of a challenge by the relevant taxing authorities. Coverage is commonly used to remove obstacles in negotiations, eliminate the need for escrows or indemnities, and allow parties to move forward with transactions.

# Tax Liability Insurance

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## When to Consider Tax Liability Insurance

In M&A transactions, coverage is commonly purchased when the issue giving rise to the need for a policy carries a low probability/high severity risk profile and neither of the transacting parties wish to bear the risk of an adverse outcome. Coverage may also be sought by Sellers in advance of a transaction if they are aware that a Buyer may raise a tax issue and demand a price concession. Finally, coverage can be considered in the context of refinancings, recapitalizations (debt or equity) or any other general tax planning situation where there is a focus on a tax position(s) that impacts the feasibility of the transaction.

### KEY HIGHLIGHTS:

- ❖ The policy covers additional taxes, interest, penalties, contest/defense costs and gross-up (income tax on the insurance proceeds).
- ❖ Insurance policies can be structured in amounts as low as \$5 Million up to approximately \$1.5 Billion.
- ❖ Premiums are between 2% and 5% of the total limits purchased.
- ❖ Retentions vary by risk, including no retention policies or retentions applicable only to defense costs.
- ❖ Policy period up to 7 years (10 years may be available for specific risks).

## Insurable Risks

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

Areas which have presented covered tax positions include:

**Mergers & Acquisitions** - Issues within the potential deal structure (i.e., validity of Section 338 elections or the applicability of tax-free/taxable reorganization treatment to the transaction) and historical tax positions by the Target (i.e., accuracy and/or usability of the Target's net operating losses, executive compensation, deferred compensation, prior restructurings or recapitalizations and/or prior acquisitions of former members of consolidated return groups)

**Fund inception/formation, Fund operations (i.e., any M&A activity), Fund exit** - Tax issues related to entering/structuring/exiting funds (including activity in foreign jurisdictions/cross-border transactions)

**S-Corporation Qualification** - Validity of S-Corp status (i.e., ineligible shareholders, disproportionate distributions, second class of stock, late S Corp election under S Corp regime etc.)

**Consolidated Groups** - Including liability of former members under Treas. Reg. 1.1502-6

**Spinoffs** - Compliance with Section 355

**REIT Status** - Including whether REIT status has been maintained

**Tax Credits** - Insurance assists in attracting tax equity investors credits (i.e., investment credits, production credits, historic credits, low-income credits, R&D)

**Multinationals** - Including transfer pricing and foreign tax credits

**Foreign Investors** - U.S. trade or business, U.S. branch issues, U.S. sourced income, permanent establishment issues, and FDAP implications.

**Tax Exempts** - UBTI treatment

**Personal Taxes, Wealth and Estate Planning** - Emerging area for tax insurance

**Emerging Product** - Tax return insurance for partnerships and corporations

## Alternatives to Tax Insurance

In the M&A context, the Buyer may demand an indemnity from the Seller, but this exposes the Buyer to Seller credit and collection risk and prevents true deal closure for the Seller. The Buyer may hold back funds or put funds in escrow, but this prevents the Seller from realizing the full sale proceeds for some time. Alternatively, Private Letter Rulings are costly, uncertain and may take longer to obtain than the transaction timeline will allow. In short, insurance is a more effective and efficient use of capital, allowing parties to move forward with certainty and closure.

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

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