

Tax Liability Insurance

What is Tax Liability Insurance?

Tax Liability Insurance (TLI) provides financial protection for taxpayers against an unexpected tax liability resulting from a challenge by a federal or state tax authority to the intended tax result of a transaction, investment or filing position.

What does Tax Liability Insurance cover?

TLI policies are tailored to each unique situation and can cover lost tax attributes as well as additional taxes, interest, penalties, costs of defending the tax dispute, and gross-up (for tax on the insurance proceeds).

Why Buy Tax Liability Insurance?

TLI is intended to manage the risk of a specific tax position being challenged and helps taxpayers obtain financial certainty to proceed with an investment, M&A transaction or tax planning in the ordinary course of business. In certain scenarios, tax insurance serves as a credit enhancement for, or in lieu of, a tax indemnity from an uncreditworthy counterparty.

When is Tax Liability Insurance Usually Purchased?

TLI is typically purchased when a taxpayer or its counterparty identifies a specific tax risk that could lead to a significant loss if successfully challenged by a tax authority. In the context of M&A transactions, TLI can address a tax issue discovered during a buyer's due diligence that carries a low probability but a high quantum of loss. Sellers also proactively use TLI as a cost-effective solution for ringfencing known tax exposures that would otherwise complicate negotiations or result in price concessions.

Tax equity investors have used TLI for over a decade to enhance the tax indemnities provided by sellers and sponsors of renewable energy projects. TLI has become a vital tool for corporate taxpayers seeking to mitigate tax risks associated with the purchase of transferable tax credits following the Inflation Reduction Act.

Public and private organizations use TLI to mitigate tax risks on a balance sheet. For instance, covering the availability of certain tax attributes, or the intended treatment of a reorganization, recapitalization or intercompany transaction, or simply to offset the financial impact of a tax reserve required by an independent auditor. TLI is a flexible and bespoke solution that continues to evolve and respond to where taxpayers need financial certainty.

What are the Alternatives to Tax Insurance?

Alternatives to tax insurance include traditional methods such as obtaining indemnities, establishing an escrow account, or seeking a private letter ruling (PLR) from the IRS. In an M&A transaction, a seller indemnity exposes the buyer to seller credit and collection risk, while an escrow to cover a potential tax liability prevents sellers from realizing full sale proceeds and ties up capital that could otherwise be invested in the business. A Private Letter Ruling (PLR) provides specific guidance from the IRS regarding the tax treatment of a transaction, but it can be costly and often exceed the time frame required for a closing, with no assurance of a favorable outcome. In each of these cases, TLI provides taxpayers with a more cost-effective, efficient and comprehensive alternative for managing tax risks.

How Much Insurance Coverage is Available?

TLI is offered by more than 20 A-rated insurance carriers. Each TLI insurer can accommodate a policy with a limit as low as \$5 million, and combined, the tax liability insurance market can support more than \$1 billion of limits of liability per risk.

What is the Cost and Term of Coverage?

TLI is paid on a one-time basis at the inception of the policy term. The cost of a policy ranges from 2% - 5% of the coverage amount which includes insurance premiums, underwriting and brokerage fees, and taxes. The cost of the insurance program depends on the nature of the tax risks being insured, the strength of risk mitigation strategies, and the amount of insurance being procured beyond any self-insured retention amount (if applicable). A TLI policy term typically lasts between 7 years, linked to the statute of limitations for the covered tax exposure, although some insurance carriers can provide a longer term (up to 10 years).

How long is the Policy in Force?

A TLI policy is a “claims-made” policy. An insured can make a claim within the policy term upon notice that the tax authority is initiating an investigation or audit related to a covered tax risk. Once the insured makes a claim, the policy term is tolled until a final determination of loss is made.

What Types of Tax Issues are Not Insurable?

Tax insurance is not available to cover abusive tax shelters, listed or reportable transactions, or for taxpayers avoiding taxes known to be payable and simply looking to play an “audit lottery”.

What Types of Tax Issues are Insurable?

TLI is a means to provide financial certainty for tax positions taken in legitimate business transactions, investments and complex tax planning supported by third-party tax advice. A few examples of insurable tax risks include:

- M&A Transactions (e.g., Eligibility for Subchapter S Corp status, tax basis step-up in 338(h)(10) and 336(e) elections)
- Small business stock transactions (e.g., Sections 1045, 1202, 1244)
- Tax credit qualification, transferability and recapture (e.g., Renewable Energy ITCs and PTCs)
- Corporate tax risk management (e.g., transfer pricing, accounting methods, foreign tax credits, corporate tax reserves)
- Pass-through structuring: Master Limited Partnerships, Qualified Settlement Funds, Hedge funds, Private Equity funds
- Tax-free reorganizations, recapitalizations, and Section 355 spin-offs
- Real Estate: REIT qualification, FIRPTA, Low-income Housing Tax Credits, Historic Rehabilitation Tax Credits
- Business capitalization issues such as debt versus equity characterizations
- Distressed asset transactions and cancellation of debt income (CODI)
- Compensation and benefits planning (e.g., Sections 83, 280G, 409A)
- Cross-border tax issues (e.g., Subpart F income, treaty benefits, withholding taxes)
- Estate and gift tax issues, settlement and succession planning
- In certain circumstances, coverage for entire corporate or partnership tax returns, or ongoing tax controversy

Don't navigate tax liability alone. Let's Talk!

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