



A Primer on Tax Insurance:

As representations & warranties insurance (“R&W”) has entered the mainstream of mergers and acquisitions, it has overshadowed the existence and importance of Tax Insurance. Tax Insurance was introduced in the U.S. marketplace around the same time as R&W. The lower use of tax insurance is interesting because while R&W smooths out the negotiation of the seller’s representations and indemnity, insuring specific tax positions is often more “deal critical”. A disagreement concerning a tax position or tax strategy can easily scuttle an otherwise attractive transaction.

A likely impediment to selling tax insurance is that it represents an entirely new vocabulary for most insurance professionals. The purpose of this document is to provide an overview of the Tax Insurance product and required submission materials, example of insurable tax issues and some case studies.

U.S. TAX SYSTEM:

As of 2014, the U.S. tax code consisted of 73,954 pages. While the Tax Cuts and Jobs Act, which passed into law in December 2017, was intended to simplify some aspects of the Internal Revenue Code (the “Code”) and to close certain loopholes, it also created new questions for taxpayers and left a still shockingly complex system for taxpayers and their advisors to navigate.

In the U.S., taxpayers confront multiple types of taxes imposed by various taxing authorities. For example, the Internal Revenue Code imposes federal income taxes, federal withholding taxes (on both wages and gains realized by non-US persons), estate and gift taxes, and excise taxes. Income taxes are imposed differently on different types of taxpayers (e.g., a corporation subject to Subchapter C, an S corporation, a trust that is a not a grantor trust, a REIT, an insurance company, etc.). A separate income tax regime, known as the alternative minimum tax, may apply if a recalculated amount of taxable income fails to yield a threshold amount of taxes under the regular tax regime.

At the state and local level, there is the potential for income taxes, sales taxes, use taxes, property taxes, transfer taxes and fees, among others.

Multinational entities must comply with a variety of specific requirements to satisfy the principle that their intercompany transfer of goods or services was made on terms that were “arms-length.”

Complexity spawns uncertainty. In addition to the annual taxes levied by the various jurisdictions, many transactions have their own unique tax characteristics that need to be carefully analyzed. These transactions are what drive the majority, but not all, of the requests for Tax Insurance.

TAX INSURANCE:

Tax Insurance provides certainty. Tax Insurance can cover a particular transaction, such as an investment in renewable energy, or the tax treatment of a spin-off, for example. Tax Insurance protects a taxpayer against the failure of a tax position in connection with a transaction, reorganization, accounting treatment, investment or other type of undertaking to be respected by the applicable taxing authority. In many ways, tax insurance is an ideal insurance product, because, when used properly, it insures against the probability of a catastrophic event. For example, if an investor purchases an asset that they believe has favorable tax attributes, the loss of those favorable tax attributes may minimize or negate the value of the transaction. For a relatively low premium, the

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A Primer on Tax Insurance

Continued.

investor is able to use Tax Insurance to lock in the favorable tax attribute, and protect the value of its investment.

Key attributes of tax insurance include the following:

CURRENT GLOBAL CAPACITY:

>\$1 billion for any one transaction.

CURRENT PRICING:

The rate on line for the primary layer of coverage is generally 3% to 6% of the limit purchased. The rate on line usually declines as additional capacity is added.

RETENTION:

Determining the proper retention for Tax Insurance is less formulaic than for R&W insurance. As a general rule, if the underwriters are less confident about the specific tax position, they may choose to set the retention at a level where they believe the taxing authority would settle. If the underwriters are more confident about the tax position, they will require either a minimal retention so the Insured has “skin in the game” or possibly no retention at all.

POLICY TERM:

Typically 6 years, but many markets can offer 7 years, if required. The premium is a one-time premium that covers the duration of the policy period.

COVERED LOSS:

The policy pays Loss resulting from a challenge to a covered tax position, which generally includes additional taxes, penalties, interest, claim expenses and a gross-up (a gross up is an additional payment to the Insured to offset the taxes due on the insurance recovery arising from a paid Loss).

COVERAGE TRIGGER:

The policy generally defines a Claim as a notification to the taxpayer by a Taxing Authority that a covered tax position is being investigated. The specifics of which costs erode the retention and when the policy begins to cover costs stemming from the investigation is negotiated as part of the policy placement process. Note that carriers

do not want to be responsible for paying the cost of routine audits (and, to this end, nor does an Insured want to be required to get an insurer’s consent to settle a routine audit matter).

SUBMISSION REQUIREMENTS:

Given the complexity of Tax Insurance and competing demands on underwriters’ time, it is particularly important to submit complete and well thought out submissions to the insurers. A submission should include the following:

- The name and address of the Named Insured
- The covered tax position(s), including a concise description of the underlying transaction and the relevant tax issue(s) to be insured. The description should provide sufficient detail so that the underwriter can rely on it when preliminarily evaluating the risk. The difficult facts also need to be disclosed – which may mean executing a non-disclosure or even a common interest agreement prior to issuing the submission. Clients and brokers often want to rush a submission to the insurers, however, in our experience, taking the time to clearly define the coverage need and the supporting facts actually leads to quicker assessments from the Insurers
- A memorandum and/or draft opinion if one has been prepared by the tax advisor
- The background of the parties involved, such as the results of any prior audits of the taxpayer, if applicable, and whether the taxpayer participates in the IRS Compliance Assurance Program, etc.
- Limit of liability being requested by the Insured
- A potential loss calculation; including, additional taxes, interest, penalties, claim expenses and gross up, if gross-up coverage is desired.

From a timing perspective, once a complete submission is provided, the underwriters can typically deliver their preliminary responses within three or four days (depending on workloads). If the initial feedback is favorable and the client wants to proceed, it is typically best to arrange a call with the underwriter to set a timeline and determine

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A Primer on Tax Insurance

Continued.

the additional information that the underwriter will require.

At this point, the underwriter should be able to provide a Non-Binding Indication Letter (“NBIL”) or proposal along with a specimen Tax Insurance policy. The proposal outlines the scope of coverage (including any key exclusions), limits, pricing and retention (deductible). If the client wants to move forward, they will need to execute the NBIL or proposal and pay an underwriting fee (which is generally around \$40,000, but may be higher or lower depending on the covered tax position). This fee offsets the underwriter’s internal costs and helps pay for any third party advisors used to underwrite the submission.

Underwriters take differing approaches to the formal underwriting process. Some provide a formal underwriting plan while others simply request a list of additional materials. The underwriter will review the information and may request an underwriting call with the Insured’s tax advisors. During the underwriting process, the covered tax position will be defined and the balance of the Tax Insurance policy will be negotiated. This process involves the Insured, the insurance brokers and the Insureds advisors.

Once the underwriting is complete and the policy is drafted, the underwriter will issue a conditional binder, which sets forth the subjectivities to bind the insurance, along with the final draft Tax Insurance policy.

Assuming the requested information is provided in a timely manner, the entire underwriting process can be completed in as little as two weeks, however three to four weeks is more common.

COVERAGE IN A TAX INSURANCE POLICY VERSUS REPRESENTATIONS AND WARRANTIES POLICY:

A R&W policy will cover a breach of the representations related to tax, but it does not necessarily track the Seller’s full indemnity obligation. As a general matter, the Tax Reps will not cover “known tax issues”, so any specific tax issues that are identified in due diligence are not covered by the R&W

policy. For example, the Tax Rep may state that “other than issues in the Disclosure Schedule, the Seller is not aware of any action or pending action by a tax authority”. This type of representation effectively puts known tax issues beyond the scope of the R&W policy.

As the market for R&W insurance has become more competitive, insurers are increasingly willing to assume liability for breaches related to pre-closing attributes and conditions assumed by the Buyer in their post-closing tax filings. However, this expansion of coverage still does not include the Seller’s specifically identified and/or disclosed tax risks.

SAMPLE OF INSURABLE TAX ISSUES:

There are a variety of insurable tax risks and each risk is unique, so the insurability of a given tax position will vary based on the specific facts and circumstances. At the same time, there are areas of tax law and certain transactions that tend to lend themselves to the effective use of Tax Insurance. This is a partial list of situations that lend themselves to a Tax Insurance solution:

1. Historic tax positions of a target entity in an M&A transaction;
2. Investment in clean energy (e.g. solar), new market, rehabilitation, and other investor tax credits;
3. Real Estate Investment Trusts (“REIT”) and their representations as to their REIT status in an acquisition;
4. Foreign tax credits;
5. Preservation of (or availability of exceptions to any limitations to) net operating losses and other tax attributes following a transaction;
6. Transfer Pricing;
7. Tax treatment of reorganizations, recapitalizations and/or spin-offs;
8. Debt v. Equity analysis;
9. Capital gain versus ordinary income treatment;
10. Deductibility of expenses (as opposed to capitalization);
11. Excessive compensation;
12. Deferred compensation;
13. Whether withholding taxes are imposed;
14. Whether distributions constitute a “disguised sale”;

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A Primer on Tax Insurance

Continued.

15. Valuation Risks; and
16. S Corporations and 338(h)(10) elections.

Coverage for the federal tax return filed for a particular year may also be available.

CASE STUDIES:

Tax Free Merger: A large multi-national corporation was contributing an existing business into a new company. The client wanted certainty that the contribution would be treated as tax-free for the corporation and their shareholders and sought a Private Letter Ruling from the IRS confirming, in advance, the expected tax treatment. When the IRS denied the request for the Private Letter Ruling, the corporation found itself in a difficult position. In order to address the risk and satisfy its shareholders' concerns, the corporation purchased a \$350 million Tax Insurance policy that would insure the company and ultimately pay the loss if the IRS successfully challenged the tax free nature of the transaction.

REIT Status: There have been many Tax Insurance policies written for REIT transactions. The acquisition of a REIT requires the seller to make similar representations and warranties as they would in a traditional corporate acquisition. However, the more meaningful

representations are related to the target's REIT status. The Tax Insurance policy insures tax liabilities stemming from post-closing challenges by the taxing authorities to the target's REIT status.

Tax Credits: Federal and State programs provide tax advantages that are designed to attract investors into socially beneficial projects (for example, programs that encourage investment in renewable energy (e.g. solar and wind) or lower income neighborhoods). The policies that protect the tax equity investor's tax benefits typically insure the project's partnership status, allocations made within the partnership, and basis and recapture risk.

Tax Insurance is a product that can have significant positive impact on a variety of transactions ranging from general M&A to tax equity investments to partnership formations. The language of Tax Insurance can be a bit daunting, but the value of these products to clients can be enormous.

We have expert resources that can assist in the placement and underwriting of Tax Insurance and we are always available to answer questions and provide our thoughts on the insurability of and process associated with specific tax risks.