Known Tax Exposures Insurable With Right Motivation

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By Emily L. Foster

Business executives who forgo investment opportunities because their tax positions have only a more likely than not chance of being sustained may be oblivious to insurance options that could reduce their risk exposure.

Tax insurance has grown significantly over the past five years, and industry participants say it has the potential to explode as it provides coverage for identified and known risks associated with a tax authority successfully challenging a taxpayer's position.

Businesses usually acquire tax insurance for issues identified during due diligence concerning the target entity in mergers and acquisitions. They do so to bridge the gaps in representations and warranties insurance, which covers unknown and unforeseen losses.

Outside M&As, tax insurance has been used to protect against potential loss of anticipated tax credit benefits in tax equity investments, such as renewable energy projects, if the structure or positions taken are challenged.

But the largest growth area has been for policies insuring companies' tax positions taken in the ordinary course of business and tax planning opportunities, Jordan Tamchin of CAC Specialty said during a February 9 webinar hosted by Alston & Bird LLP. Tamchin, an insurance broker, cited examples of this practice in transfer pricing, corporate restructuring, tax treaty qualifications, and subpart F inclusions.

Scott A. Harty of Alston & Bird explained that tax insurance is designed to put the insureds in the same position they would have been in had the tax liability not arisen. The policies therefore cover "the gamut of exposure of the insured," he said, noting that this includes not only the tax liability that might arise from the covered tax position, but also the expenses of potential audits and controversies with the tax authority; a gross-up of the insurance proceeds in case they are taxable; and interest, fines, and penalties.

Thus, transferring the economic risk of the tax loss to the insurance market "allows the insureds to execute the underlying transaction or investment with complete tax certainty and provides them with a level of comfort similar to a private letter ruling issued by the taxing authority," Tamchin said.

The policies typically cover claims made within the applicable statute of limitation but in some cases may extend beyond seven years, Harty added.

Austin Cahill of Alliant Insurance Services Inc. noted the three major steps of obtaining tax insurance: a broker prepares the submission and markets the tax risk to insurance providers, the insurer conducts its underwriting process including reviewing diligence, and the parties negotiate the policy.

Cahill said that as an insurance broker, when preparing a submission he considers the client's independent tax adviser's substantive review supporting the covered tax position. The level of diligence required in that review depends on the complexity of the risks, he added.

A frequent question about tax insurance is whether the level of comfort opinion that insurers require from the adviser is more likely than not, should, or will, Harty said.

Demystifying Opinion Levels

Insurance companies generally can insure tax issues with a more likely than not and above opinion level. Tamchin noted that taxpayers might seek that level rather than a should-level opinion for several reasons, such as lower cost and faster process. He also said that insured positions have sometimes been supported by a will opinion, which means at least a 90 percent chance of succeeding on the merits.

Whether taxpayers can obtain a should-level opinion could depend on the underlying issue and the expertise of the firm issuing the opinion. Tamchin noted that advisers generally "aren't willing to provide a should level of comfort on issues dealing with factual matters," so taxpayers can only get opinions on those issues based on a more likely than not standard.

In the early days of tax insurance, insurers generally required a should-level opinion, but as the market has matured, that has changed, according to Cahill. However, he emphasized that what matters is the taxpayer's motivation for the transaction and for seeking insurance, along with the reasons for the more likely than not opinion.

Daniel Berger of American International Group Inc. explained that insurance companies generally seek to insure risks regarding "positions that have a reasonable basis, that are supportable, [and] that are not abusive."

Whether a risk can be insured will depend on the context rather than the opinion level, Berger said. "We're really focused on the quality of the advice and the analysis."

"The fact that it's usually a more likely than not or better position that is being insured . . . makes clear what we're not insuring is highly uncertain risks," added William Kellogg of Berkshire Hathaway Specialty Insurance. "The insurers are not playing the audit lottery; we're not here to just make a bet that something is not going to get audited," he said.

Insurers take on the risks for which they think the taxpayer took the right position, Kellogg said. "We know there's risk, but we just want to make sure that we feel we're on the right side of it."

Compelling Motivators

Kellogg also emphasized that insurers consider motivation when analyzing a risk — whether it's for M&A transactions, tax credits, or an operational aspect of the business. He said a predominant motivator for tax insurance is protecting against a significant exposure that has a low probability of occurring, and that's what insurance companies are paid to do.

Businesses may have other motivations that reasonably support their quest for insurance. For example, in an M&A transaction, Kellogg said acquirers might seek better terms than otherwise provided by the seller's indemnity — for example, having a seven-year insurance policy versus an indemnity backed by a two-year escrow period.

Also, acquirers in an M&A transaction or tax equity investors in a renewable project seeking added certainty might place insurance with a company that has a better credit rating than the indemnity provider or the project developer or sponsor, Kellogg said.

On the flip side, sellers in an acquisition deal "might want to eliminate their risk of having to pay out a significant indemnity payment," Kellogg noted, emphasizing that tax insurance enables sellers and buyers to lock in the economics of the transaction.

Kellogg observed that "in some limited contexts, tax insurance is advantageous because it can be obtained faster than a letter ruling." For example, if the buyer identified in its due diligence something that might have led to an inadvertent termination of the target's S corporation status, the parties might purchase insurance because they don't want to delay the closing of the deal. Kellogg said that in that case, the ruling request will be filed later.

Tax insurance also provides a vehicle for exploring some operational tax planning strategies that might otherwise be left on the table — namely, opportunities for which there is a catastrophic downside to the company's financial status, with a low probability of occurring, but substantial upside with meaningful benefits for the company, Kellogg said.

In those situations, Kellogg emphasized the advantages of seeking tax insurance on the front end so that the insurer considering underwriting a policy is involved.

Insurance companies could question the motivation of taxpayers that try to place tax insurance several years after a specific tax planning strategy is undertaken, Kellogg said.

More Risks Covered

Changes in tax law — namely, the Tax Cuts and Jobs Act and the Coronavirus Aid, Relief, and Economic Security Act (P.L. 116-136) — have spawned new tax insurance policies but not to the level the market might have anticipated.

The coronavirus pandemic might have been a contributing factor to that result, with the tax insurance market being affected by M&A transactions dropping sharply early in the pandemic followed by an uptick and later a flurry toward year-end in anticipation of an increase in corporate tax rates under the Biden administration.

Nevertheless, the diversity of tax risks being insured is expanding beyond the traditional issues, Harty said. He noted that submissions have covered state and local taxes, employee benefits, and section 409A deferred compensation rules.

As awareness of the product increases, “you’re just seeing more risks getting insured, but they are not driven by tax law changes from what I can tell,” Harty told *Tax Notes*. Some policies stemmed from tax law changes, but it wasn’t anything “transformational or broad-based,” he added.

Net operating losses aren’t an uncommon risk to insure, and with the loss carryback provision in the CARES Act, Harty expected that more businesses would have sought insurance coverage for risks associated with those losses.

The CARES Act modified section 172 to address liquidity issues arising from the COVID-19 pandemic by temporarily repealing the TCJA’s 80 percent NOL limitation and allowing deductions for loss carryovers and carrybacks to fully offset taxable income for tax years beginning before January 1, 2021. The law also allows companies to carry back losses arising in tax years beginning in 2018 through 2020 for up to five years before the year of the loss.

Cahill and Tamchin told *Tax Notes* that their firms have seen several submissions that insure the validity of a tax refund claim arising as a result of the ability to carry back NOLs. They said those policies insure not only the validity of the refund claim but also any offset if the IRS challenges tax positions taken on the prior-year return to which the NOL is being carried back.

With companies starting to look at carrying back 2020 tax year losses, more taxpayers might think about the quality of their NOLs and whether they need to be concerned about the tax year in which they are carrying back the losses, Tamchin said.

Cahill said that for M&As, buyers seeking to obtain better financing for the acquisition of a target company that is expecting to file a refund claim have obtained tax insurance policies to “prove to the lender that this amount of cash is coming, and is coming soon.”

Regarding TCJA-related issues, tax insurance has been used to reduce the risks of improper asset characterizations for purposes of the section 168(k) bonus depreciation rules and to insure the valuations for buildings and land so taxpayers have certainty about the depreciation amount, according to Cahill.

The calculation of the section 965 transition tax in an M&A context is another TCJA-related risk insured because of the uncertainty as to whether the target properly determined the liability, Tamchin said.

Tamchin surmised that buyers’ due diligence of target companies in M&A transactions in the coming years could uncover issues regarding how companies applied the TCJA provisions, prompting consideration for tax insurance to mitigate the risks.

Jordan said he thinks that as companies, law firms, and accounting firms learn more about the use of tax insurance outside the M&A context, “it’s going to pick up steam because a lot of companies forgo undertaking certain transactions . . . despite them having a more likely than not level of comfort on a position.”

The tax insurance market seems poised for growth as new players — brokers and insurers —

entered the domain in 2020 in anticipation of a huge boom, according to Cahill. “I think we’re still expecting that.”