Tax Insurance: Protecting against unexpected tax liabilities

2020 tax insurance market snapshot

- Substantial growth over last 3 - 5 years
- Over 10 primary underwriters creating a competitive pricing environment
- Policy submissions up by more than 30% in 2019
- Total capacity in excess of $1.5 billion
- Global market for coverage of U.S. and non-U.S. taxes
- Available across all industry classes and all tax types (e.g., corporate, individual, employment, VAT, sales and use taxes)
- Pricing typically between 2.5% and 5.5% of the amount of tax coverage purchased
- Retention generally limited to cover contest costs only – ranging from $50,000 to $250,000
- Policy period up to 7 years but extended 10-year period available for tax risks requiring longer coverage periods
- One-time premium payment

Tax laws are complex and with complexity comes uncertainty. Taxpayers are often faced with having to take a position on a complex and uncertain tax matter that if successfully challenged by a tax authority could potentially result in the assessment of significant taxes, interest and penalties that can have a material impact on the financial condition and earnings of the taxpayer. Tax insurance was developed to eliminate the uncertainty inherent in tax compliance by transferring the risk of loss arising from an insured tax risk from the taxpayer to an insurance company.

Coverage available for wide range of tax risks, including

- Taxation of carried interests
- Tax credit qualification (wind, solar, rehab, new markets, foreign, state, etc.)
- Tax-free spinoffs, mergers and other tax-free intended transactions
- REIT status
- S corporation status
- 338(h)(10) and 336(e) basis step-up elections
- NOL calculations and 382 limitations
- E&P calculations
- Cancellation of debt (COD) income and related exceptions
- Bad debt and worthless stock deductions
- Rights to claimed tax refunds
- Transfer pricing compliance
- Partnership allocations
- Debt/equity characterization
- Capital vs. ordinary treatment
- Capitalization and cost segregation studies
- Deferred compensation, 409A and 280G matters
- Treaty qualification
- Withholding tax obligations
- CFC/PFIC status
- GILTI and Subpart F inclusions
- Real and personal property transfer tax matters
- State and local tax matters
- Non-U.S. tax matters (e.g., VAT, PE status, treaty qualification)

Coverage is not available for all tax risks or positions. For example, coverage is never available for abusive transactions, including listed transactions and transactions lacking economic substance or business purpose.

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Key policy features

Tax insurance is designed to protect a taxpayer against financial losses suffered if the insured tax risk or position is challenged by a tax authority. In the event of a challenge, a tax policy will compensate the insured for:

- Taxes assessed by a tax authority in respect to the insured tax risk or position
- Interest and penalties (other than for fraud)
- Defense and contest costs (subject to a low retention amount, generally $50,000 to $250,000)
- Gross-up amounts for taxes due on receipt of insurance proceeds

Circumstances warranting tax insurance

Tax insurance should be considered prior to and in conjunction with implementing any M&A transaction, investment or fund structure, business reorganization, and personal or business tax planning opportunity.

In an M&A context, tax insurance should be considered:

- By a seller in anticipation of a sale to address a known tax risk prior to sale and to facilitate an expeditious sales process
- By a buyer in the bidding process to make its bid more competitive
- To cover a known tax risk that is excluded by a "Representation and Warranty" insurance policy

Outside an M&A context, tax insurance should be considered anytime:

- The tax characterization of a transaction or tax position of a taxpayer is susceptible to challenge by a tax authority
- Absolute certainty of a tax structure or entity's tax treatment (as a REIT, S corp., partnership, etc.) is integral to a shareholder, investor or lender, or integral to achieving a desired tax result
- A private letter ruling is unavailable or too time consuming to obtain
- An issue is identified in a live tax audit
- Tax equity is desired to monetize tax credits in a renewable energy project or other project generating tax credits

Tax insurance may also be utilized to mitigate or offset the financial statement impact of a FIN 48 reserve.

Pricing, duration, capacity and timing

Pricing is based on a single premium payment at inception of the policy term and is typically between 2.5% and 5.5% of the amount of tax coverage purchased. Pricing, however, is heavily dependent on the tax risk being insured and can be affected by several factors, including:

- Strength of taxpayer's position
- Likelihood of challenge
- Taxes and jurisdictions implicated
- Dollar amount of tax coverage purchased
- Dollar amount of tax risk retained by the insured
- Availability and scope of legal precedent and support in favor of taxpayer's position

Insurers generally offer up to seven years of coverage which is designed to coincide with the length of time a claim may be made by a tax authority although extended periods of up to 10 years are available for production tax credits and other tax risks warranting extended coverage periods.

Total capacity of over $1.5 billion is currently available in the market to insure a single tax risk. Capacity continues to rise as additional insurers enter the tax market.

Placement of a tax policy can be completed within one to two weeks depending on the complexity of risks to be insured and the accessibility of relevant information.

Willis Towers Watson capabilities

In 2019, Willis Towers Watson's Transactional Risk Group handled more than 900 M&A deals and placed in excess of $15 billion in transaction insurance limits globally.

We bring a unique combination of risk expertise and a deep understanding of tax law and accounting principles to help our clients achieve their investment and tax planning objectives with the least amount of peripheral tax and accounting risk. Our deep knowledge and range of tax insurance solutions are key to effectively addressing varying tax risks encountered in M&A transactions, investment structures and overall tax planning.

Our tax insurance team is comprised of seasoned tax law professionals with extensive experience in handling complex domestic and international tax matters across a wide range of industries. We also work closely with our international tax team to coordinate tax coverage globally.

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About Willis Towers Watson

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