

Tax Insurance

Protecting against unexpected tax liabilities



Tax insurance eliminates the uncertainty inherent in tax compliance by transferring the risk of loss arising from a tax challenge to an insurance company.

Tax laws are everchanging and complex, and often fail to provide certainty when applied to a taxpayer's particular facts. The financial consequences of that uncertainty can be severe if the tax reporting position of the taxpayer is successfully challenged by a tax authority.

Tax insurance solves this problem by transferring the risk of financial loss arising from a tax challenge to an insurance company. Additionally, it allows taxpayers more certainty to meet financial goals, structure transactions, and solve for other contingent exposures that arise during business and tax planning.

WTW's tax team has experience in placing coverage for a wide range of tax risks, including:

- Tax-free treatment of spinoffs, mergers, recapitalizations and other tax-free intended transactions
- Tax credit qualification (wind, solar, carbon capture, rehabilitation, employee retention credits, etc.)

- Real Estate Investment Trust (REIT) status and dealer property issues
- S corporation status and inadvertent terminations
- Availability of 338(h)(10) and 336(e) basis step-up elections
- Net operating losses (NOLs) and section 382 limitations
- Cancellation of debt (COD) income and related exceptions
- Bad debt and worthless stock deduction
- Transfer pricing, cost segregation and valuation studies
- Partnership allocations and partnership level tax audits
- Debt/equity characterization
- Capital vs. ordinary income treatment
- Employee benefit plan qualification
- Excessive and deferred compensation matters
- Estate and gift tax matters
- State and local tax matters
- Withholding tax obligations
- Portfolio interest exemption
- Tax residency status
- Non-U.S. tax matters (e.g., VAT, permanent establishment, tax treaty qualification).



Tax insurance market snapshot

- Global market for coverage across a wide range of jurisdictions (U.S. and non-U.S.) and industry sectors
- Over 20 North American insurers creating a competitive pricing environment
- Underwriting process can be completed within a two-week time frame
- Total capacity in excess of \$1.5 billion available for each tax risk
- First dollar coverage available for most tax risks
- Policy period of seven to 10 years specifically designed to coincide with the length of time a claim may be made by tax authority
- One-time premium payment.

Key policy features

Tax insurance is designed to protect a taxpayer against financial loss suffered if the insured tax treatment 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
- Interest and penalties (to the extent insurable)
- Defense and contest costs to defend the tax matter
- Taxes incurred on receipt of insurance proceeds (known as a “tax gross-up”).

Circumstances warranting tax insurance

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
- To replace or reduce escrow required to cover a known tax risk.

More generally, tax insurance should be considered anytime:

- The tax characterization of a transaction or taxpayer’s reporting position is susceptible to challenge by a tax authority
- Absolute certainty of a tax structure or entity’s tax treatment (as a REIT, S corp., QSub, DRE, 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 not practical given cost and timing
- A tax audit is initiated
- Tax credits are key to successfully funding a renewable energy project or other project qualifying for tax credits.

Tax insurance may also be utilized to manage the financial statement impact of an ASC 740-10 (formerly known as FIN 48) reserve for uncertain tax positions.



WTW capabilities

WTW’s Tax Insurance team brings a unique combination of risk expertise and tax knowledge to every tax insurance placement. Our deep tax knowledge and range of tax insurance solutions are key to effectively address varying tax risks encountered in M&A transactions, investment structures and overall tax planning.

Our tax insurance team is comprised of seasoned tax professionals with vast experience in handling complex domestic and international tax matters across a wide range of industries.

Tax insurance case studies

The following case studies illustrate how tax insurance has been used by WTW to address deal-sensitive tax issues and to allow our clients to achieve their business and investment objectives without any tax risk.

Valuation — S corporation built-in gain

Challenge: Shareholders of an S corporation (that was previously taxed as a C corporation) were approached to sell the business operated by the S corporation within the applicable five-year built-in gain (BIG) period. The purchase price vastly exceeded the value obtained by appraisal for purposes of establishing the net unrealized BIG at the time of the C-to-S corporation conversion. The shareholders were concerned that the purchase price could be used by the IRS to challenge the original appraisal obtained for fixing the value and net unrealized BIG at the time of conversion, which if successful would result in corporate-level BIG tax in addition to the tax imposed on the shareholders.



WTW solution: A tax insurance policy was secured to protect the selling S corporation and its shareholders from any loss resulting from a successful challenge by a taxing authority of the appraised value that was used to support the net unrealized BIG at the time of the C-to-S conversion.

Earn-outs — Merger consideration vs. compensation

Challenge: The deal terms of a merger included providing selling equityholders with earn-out payments over a three-year period that were partially contingent on their continued full-time employment.

The equity holders were concerned that the payment of the earn-out amounts could be viewed as compensation for the equity holders' services, which would result in such payments being treated as ordinary income instead of qualifying for capital gains treatment.



WTW solution: A tax insurance policy was placed for the benefit of the selling equity holders to protect them from any loss resulting from the recharacterization of the earn-out payments as compensation.

REIT — Hybrid R&W and Tax Insurance policy

Challenge: Private equity fund desired to sell the shares of a REIT owning a ~\$2B portfolio consisting of over 50 office buildings to a newly established fund that was managed by the same fund manager. Sellers wanted to achieve a clean exit and have no continuing post-closing exposure with respect to the representations and warranties they were being asked to make in the transaction agreement. Buyer required an insurance solution that would stand in the place of a sell-side indemnity and that would also cover target's qualifications as a Real Estate Investment Trust (REIT) for federal income tax purposes.



WTW solution: A single comprehensive hybrid REIT R&W and tax insurance policy was utilized to cover buyer for any losses arising from (i) a breach of the representations and warranties made by the seller in the transaction agreement, and (ii) the failure of target to qualify as a REIT for federal income tax purposes.

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Renewable energy tax credits — ITCs

Challenge: To attract tax equity investments in a utility scale solar energy project, the sponsor of the project agreed to indemnify the tax equity investors for any losses resulting from a tax authority disallowing any portion of the investment tax credits or other tax benefits allocated to them (including because of a recapture event). The sponsor desired to eliminate the financial exposure it could have under the indemnity.



WTW solution: A tax insurance policy was obtained to act in place of the sponsor's indemnity which allowed the sponsor to free itself of its indemnification obligation.

Bankruptcy — Tax refund

Challenge: A bankruptcy trustee filed a refund claim with the IRS for unused AMT credits. The refund was paid to the bankruptcy trustee but remained subject to further IRS and JCT review. The trustee desired to distribute the refund to the creditors of the bankruptcy estate, but the trustee was concerned that the IRS could later potentially seek to clawback the cash refund.



WTW solution: To address the bankruptcy trustee's concern and allow for the immediate distribution of the cash that was refunded, a tax insurance policy was obtained to cover any loss resulting from an IRS challenge of the refund claim.

Transfer pricing — Hard-to-value intangibles

Challenge: An emerging company commissioned a transfer pricing study to determine the appropriate arm's length pricing for its intercompany transactions with non-U.S. affiliates. The study covered pricing for the company's cross-border licensing arrangement of hard-to-value intangibles and charges for costs of goods sold. The company desired to mitigate its tax exposure related to the uncertainty of its transfer pricing and the impact it could have on its financial statements if it were required to fully reserve for the uncertain tax liability under FASB ASC 740-10.



WTW solution: A tax insurance policy was obtained by the company to cover any financial loss (including taxes, interest, and penalties) resulting from a successful challenge by the IRS of the company's transfer pricing methodology. The policy eliminated the company's economic exposure to any IRS adjustment and helped mitigate the reserve it was required to post on its financial statements.

BBA — Partnership audit coverage

Challenge: Certain investors in a business operating in LLC form desired to sell their membership interests back to the LLC. The exiting members also desired a clean exit with respect to all pre-closing tax matters (including federal income taxes that would otherwise flow through to them on their individual returns). To achieve this result, the LLC agreed to forgo making a "push-out" election with respect to any partnership audit adjustment relating to a pre-exit period. The solution, however, operated to shift the associated tax burden to the non-exiting LLC members.



WTW solution: To address the inefficiency of the arrangement, a tax insurance policy was obtained by the LLC to cover any losses resulting from a partnership level adjustment under the Centralized Partnership Audit Regime. This enabled a clean exit for the departing members and concurrently operated to protect the LLC and the non-exiting members from any income tax exposure related to the pre-exit period.

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About WTW

At WTW (NASDAQ: WTW), we provide data-driven, insight-led solutions in the areas of people, risk and capital. Leveraging the global view and local expertise of our colleagues serving 140 countries and markets, we help you sharpen your strategy, enhance organizational resilience, motivate your workforce and maximize performance. Working shoulder to shoulder with you, we uncover opportunities for sustainable success — and provide perspective that moves you. Learn more at wtwco.com.



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