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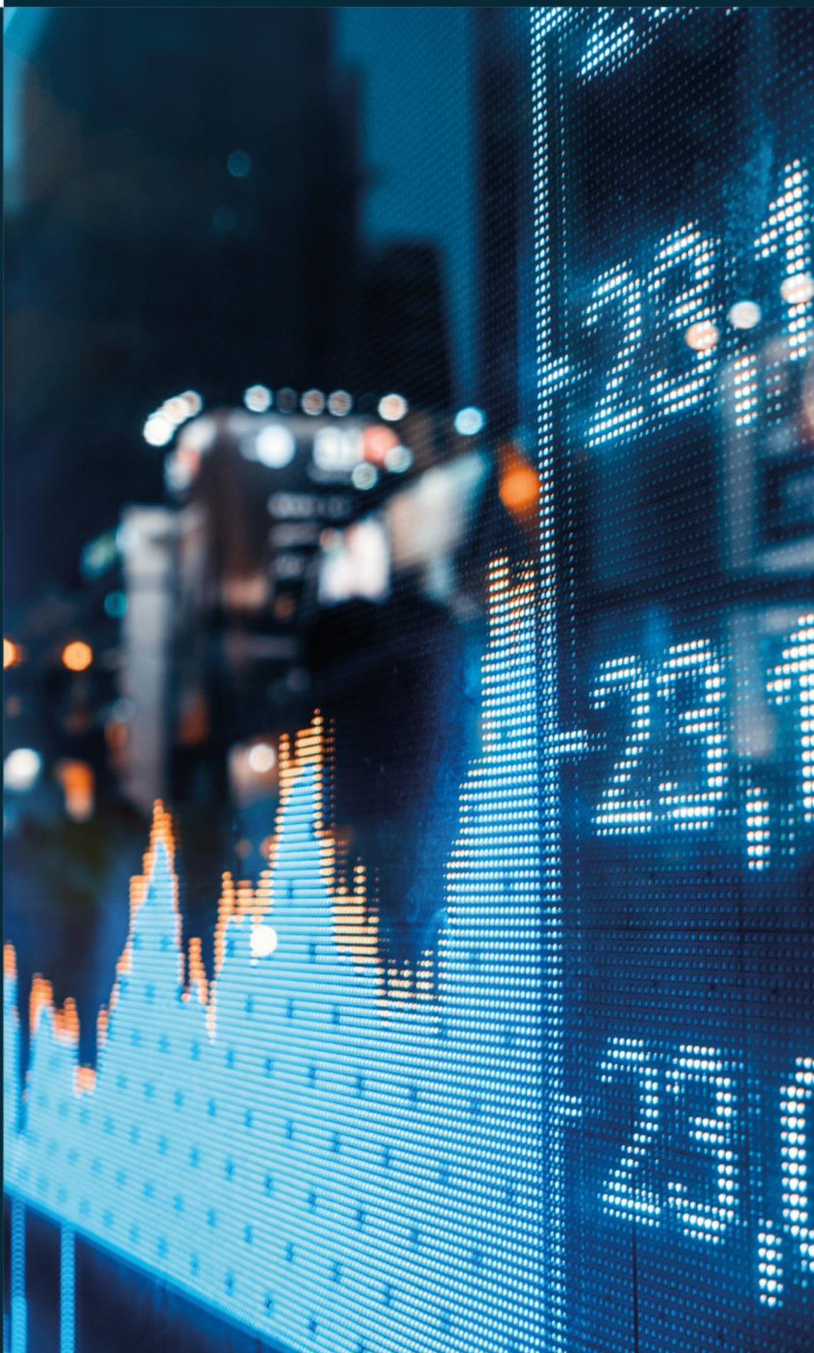
Tax Insurance:

Using insurance to remove potential tax exposures



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Using insurance to remove potential tax exposures

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Increased competition between insurers (four main tax markets in 2016, now 10+ credible markets) together with increased understanding of and demand for specific tax insurance products in both transactional and operational scenarios, has led to tax insurance becoming a commonly used tool for mitigating tax risks arising in a wide range of circumstances, most commonly those identified in M&A transactions.

HWF are able to structure insurance backed solutions to ring-fence potential tax issues providing certainty if that issues crystallises.

When can tax insurance be advantageous?

- Low risk & high quantum and certain medium/higher risk tax issues identified as part of the M&A due diligence process that are likely to be excluded from any W&I policy.
- Protection against operational tax risks (e.g. VAT, transfer pricing, tax residency etc).
- Insuring non M&A transactional tax risks (e.g. arising due to reorganisations, refinancings etc).
- In a pre-sale or carve-out context, ensuring that known risks are covered prior to a sale process in order to minimise due diligence issues.
- For private equity, protection against fund level risks (e.g. permanent establishment, taxation of management LLP level income etc).

Tax insurance for operational tax risks

- With tax authorities taking a more robust approach, businesses increasingly need to maintain a cautious approach to their tax affairs.
- Where a business has concerns over its current or historical tax treatment it can look to offset this risk with tax insurance.
- Alternatively, it may be the case that a business has a balance sheet provision for a particular tax issue and tax insurance can also be used to give certainty allowing the release of capital.

Tax insurance for M&A transactions

- Quantification and likelihood of crystallisation of a potential tax risk identified in a M&A transaction is often a key negotiation point between the buyer and seller.
- Such tax risks can be dealt with by way of indemnity or price chip/escrow but this will have a negative impact on the seller.
- Occasionally, tax issues with a significant perceived quantum can stall the transaction’s progress.
- Tax insurance can be a cost effective and commercial way of dealing with these potential uncertainties.

Developments in tax risk insurance

- Historically, only legal interpretation tax risks arising in Western European or North American jurisdictions could be insured
- More recently, more “factual” tax risks (e.g. valuation risks, substance risks, etc) have been insured.
- Geographical focus widened to most of Europe, North America and Australasia, and parts of Asia and South America.
- Typically disclosable schemes and more aggressive tax planning are not insurable.

CONTINUED OVERLEAF

Pricing of specific tax insurance:

- Premium rate is based on the limit required for the policy.
- Limit includes the potential tax exposure, interest, penalties, defence costs and tax gross-up (if necessary).
- Typical range of premium rate is between 1% and 7% (subject to minimum premium).
- IPT based on the rate in the jurisdiction of the insured entity.
- Excess normally small and in relation to defence costs only.
- Insurer may require small fee for engaging their advisers.

Key Points:

- Policy can directly insure a tax issue or sit behind a contractual indemnity.
- The costs associated with defending any tax authority challenge are often covered.
- Policy term typically matches the statute of limitations in the relevant jurisdiction (typically 7 years).
- Policy will either insure the whole liability or provide cover in excess of the probable outcome.
- Policy will exclude fraud of the insured party including wilful concealment of key information from insurers.

Some recent examples of specific tax insurance policies

Specific tax risk – non-resident capital gains tax

1. Risk of non-resident capital gains tax potentially crystallising on acquisition of a European headed group in respect of a South American tax resident subsidiary.
2. Non-resident capital gains tax arises on indirect acquisition if the market value of the relevant subsidiary is at least 20% of the wider group.
3. Both Purchaser and Vendor agreed the tax treatment however disagreed over the market value of the South American subsidiary.
4. Vendor provided the Purchaser a tax indemnity with the right to be released if specific tax insurance was obtained in respect of the risk.
5. Policy limit $150m, Vendor released from indemnity.

CONTINUED OVERLEAF

Specific tax risk – application of participation exemption on exit of portfolio holding

1. Application of participation exemption to exempt from tax the disposal of a portfolio group
2. The group was still in the development phase (i.e. pre-trading)
3. Uncertain from the tax advice whether the participation exemption would apply
4. Given the potential tax at stake, the Vendor could not get comfortable with risk that the participation exemption may not apply.
5. Policy limit €270m, insurance tower built with several insurers to provide full cover.

Specific tax risk – appropriation of UK land options

1. UK corporation tax on appropriation of land options from trading stock to fixed assets investments
2. Treated as market value realisation of the assets at the point of appropriation.
3. Both Purchaser and Vendor agreed the tax treatment of the appropriation.
4. The covered tax risk was in relation to the market value of the land and the original cost and trading WIP that resulted in the profit on appropriation subject to tax.
5. Policy limit £15m, process completed in less than 2 weeks.

About us

HWF is a specialist independent M&A insurance broker and advisor led by senior professionals with extensive experience in M&A transactions.

The team works with many leading legal and financial advisors and provides services to private equity, infrastructure funds, corporates, management teams, real estate firms and banks.

The team have over 100 years of combined experience in this market and have advised on over 2,000 global M&A deals, with values ranging from £5m - £10bn.

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