HWF

All is not lost

Insuring the availability of tax assets

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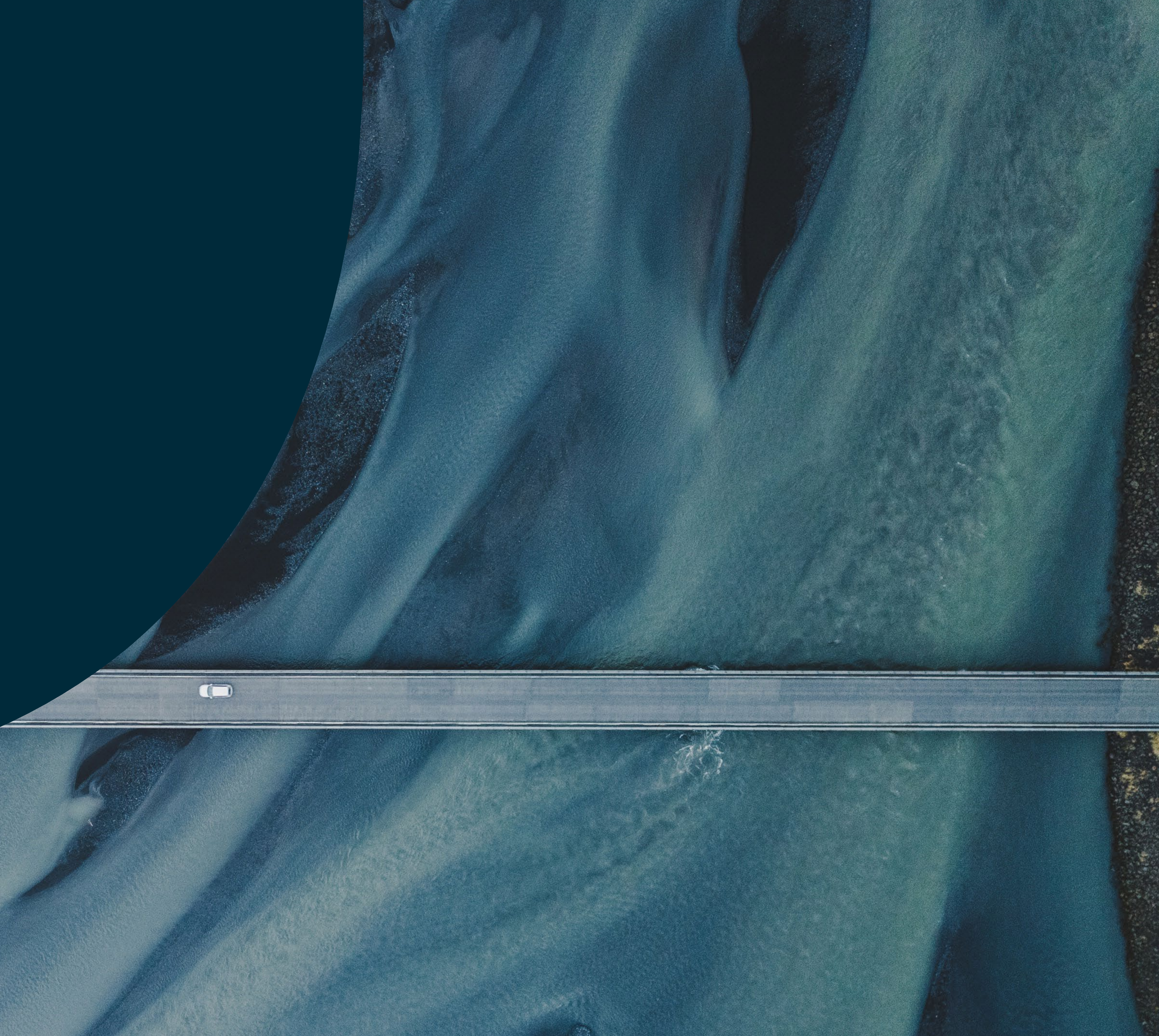


Insurance for tax assets is increasingly available in respect of M&A transactions. In this briefing we look at how tax assets can be insured through a Warranty and Indemnity ("W&I") policy (or a specific policy) to not only protect historical utilisation, but also provide ongoing certainty where value has been attributed to them within funding models.

Where the use of tax assets within a target group has been factored into the purchase price, it should no longer be the case that a purchaser accepts a blanket exclusion in the W&I policy in respect of their future existence, nor should it be necessary to purchase standalone cover for these in the majority of cases.

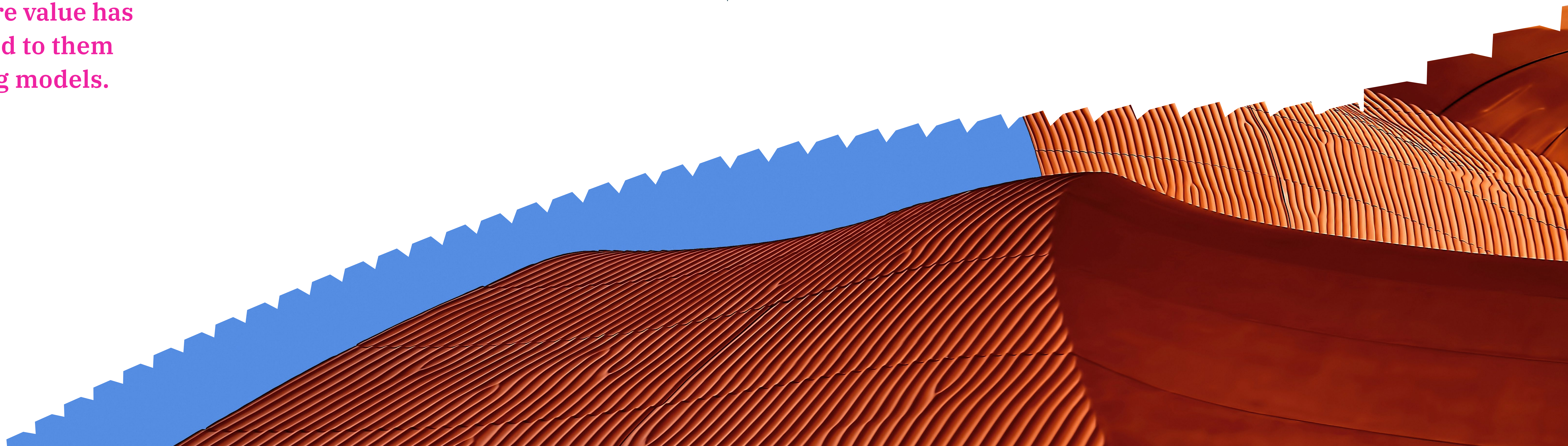
Whilst the coverage available for loss of tax assets (and its cost) will vary depending on the type of tax asset, the target group activity, due diligence and the coverage requirements, there are now more options available to purchasers seeking to unlock value in their future availability.

Insurers have historically excluded W&I cover for loss of tax assets broadly due to the risk of change in ownership rules applying to disallow such tax assets; lack of adequate due diligence and the forward looking nature of their use when priced into a transaction.

However, these assets are robust in many instances and, therefore, whilst insurers will not insure the utilisation of these assets, their existence at completion is capable of cover.

HWF has been working with insurers to improve coverage for tax assets within the W&I policy and the purpose of this article is to explain how broad protection can be achieved. Whilst specific tax insurance policies can be used to cover tax assets, in our view the additional cost and effort of seeking a specific policy for this type of protection is unnecessary in the vast majority of cases unless there is a specific technical concern e.g. impact of change in ownership rules.

There are many different types of 'tax asset' but the most common examples are capital allowances and tax losses.



> "The basis for establishing coverage for tax assets is isolating their existence in the acquisition funding model. Once isolated, an insurance policy can correctly capture and respond to loss."
>
> **Tim Dobbing**
> Associate Director, Tax

Capital Allowances

Capital allowances can be of great importance in terms of shielding future profits from corporation tax, in particular, for asset heavy business sectors (e.g. infrastructure and manufacturing).

In developmental or early-trading phases, companies can build up significant pools of capital allowances as the available allowances have been 'disclaimed' due to there not being sufficient profits available to use them.

For M&A transactions occurring during these phases (and depending on the sector), value is indirectly attributed to them by virtue of their inclusion in the funding model (i.e. reducing corporation tax and, therefore, increasing post-tax profit).

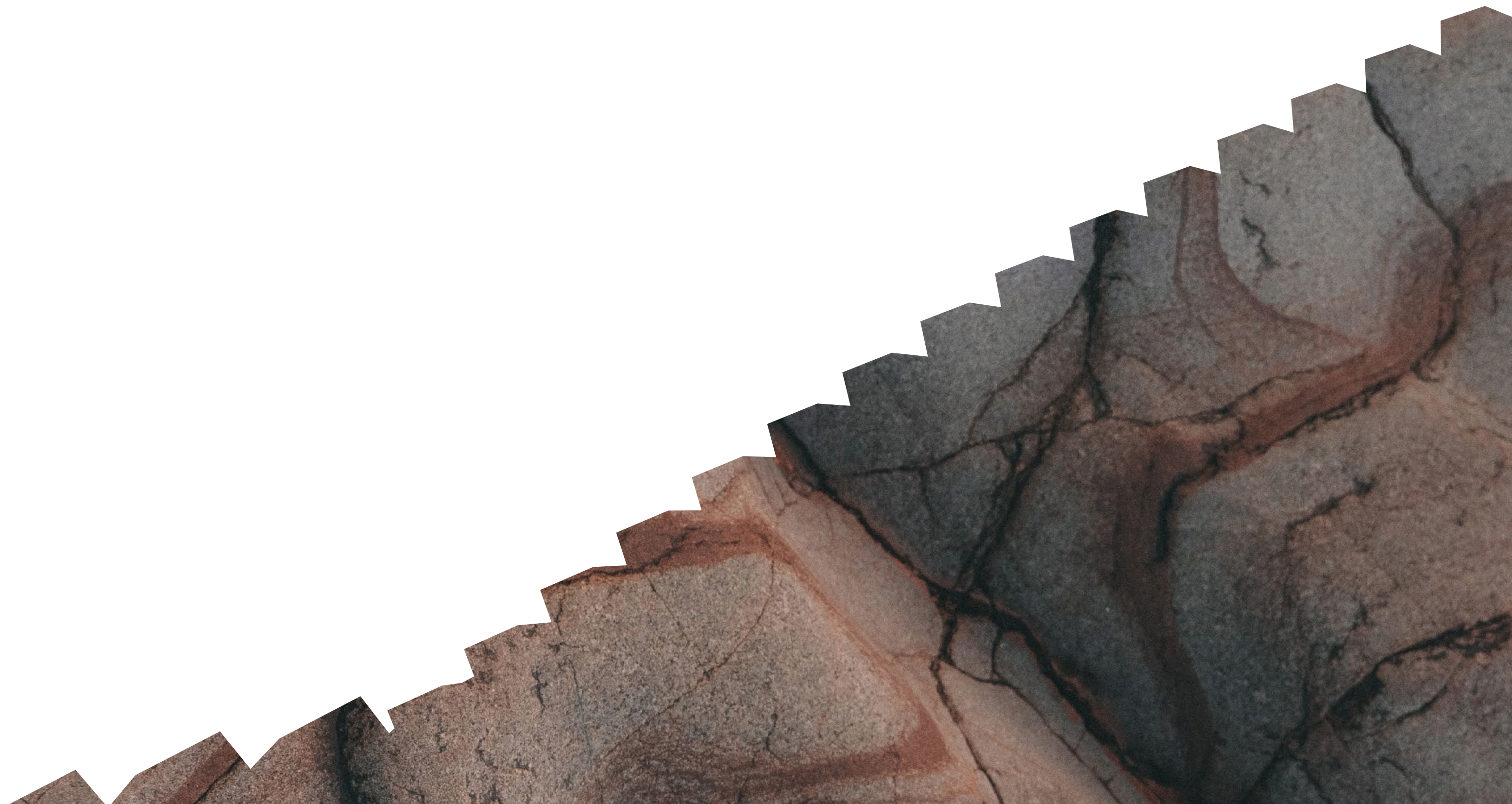
As such, the basis of achieving cover for capital allowances stems from identifying what is effectively being paid for the asset in the transaction consideration; ordinarily this can be evidenced by running the transaction model with and without the capital allowances assumptions, with the difference in acquisition consideration representing the value attributed to the asset.

Tax Losses

Similarly to capital allowances, tax losses can have significant impact in terms of reducing future corporation tax.

Conceptually, tax losses are more straightforward than capital allowances (i.e. there is no pool that unwinds) and there is normally more flexibility in their use, although there can also be more restrictions depending on the type of tax losses in question (trading, non-trading etc.).

As with value attribution to capital allowances on transactions, ascertaining the impact of losses within the funding model is the most simple method of demonstrating the impact on transaction value if they are disallowed, which again provides the starting point for ascertaining what coverage is required.



Achieving Coverage

Where tax assets have influenced the purchase price, purchasers can ordinarily seek cover for tax assets in the Share Purchase Agreement ("**SPA**") through two mechanisms:

a. tax warranties are included to confirm the value of available tax assets at the transaction reference date and (in respect of capital allowances) the qualifying nature of expenditure; and/or

b. the tax indemnity provides general protection for deferred tax assets to the extent they are included within the transaction accounts, or it provides specific protection as to the availability of a certain level of losses/allowances.

We have also increasingly seen synthetic methods for covering the existence of tax assets, the most common of these are as follows:

'Loss of value' cover

This covers the reduction in the value of shares to the extent that the tax asset has been reduced in value/does not exist. For example, if the acquisition funding model demonstrates that £5m of the purchase price has been attributed to a £25m tax asset and HMRC successfully challenge that the tax asset should be £15m, which results in the model showing that the reduction in what would have been paid for the target group was £2m, the insured is able to claim for this £2m.

Effectively, this means that the insured can claim for a reduction in the tax asset on the same basis as it has given value for it in the model (e.g. if it paid 20p in the £1 for the tax asset, it can claim 20p in the £1 for every £1 of tax asset lost from the ground up).

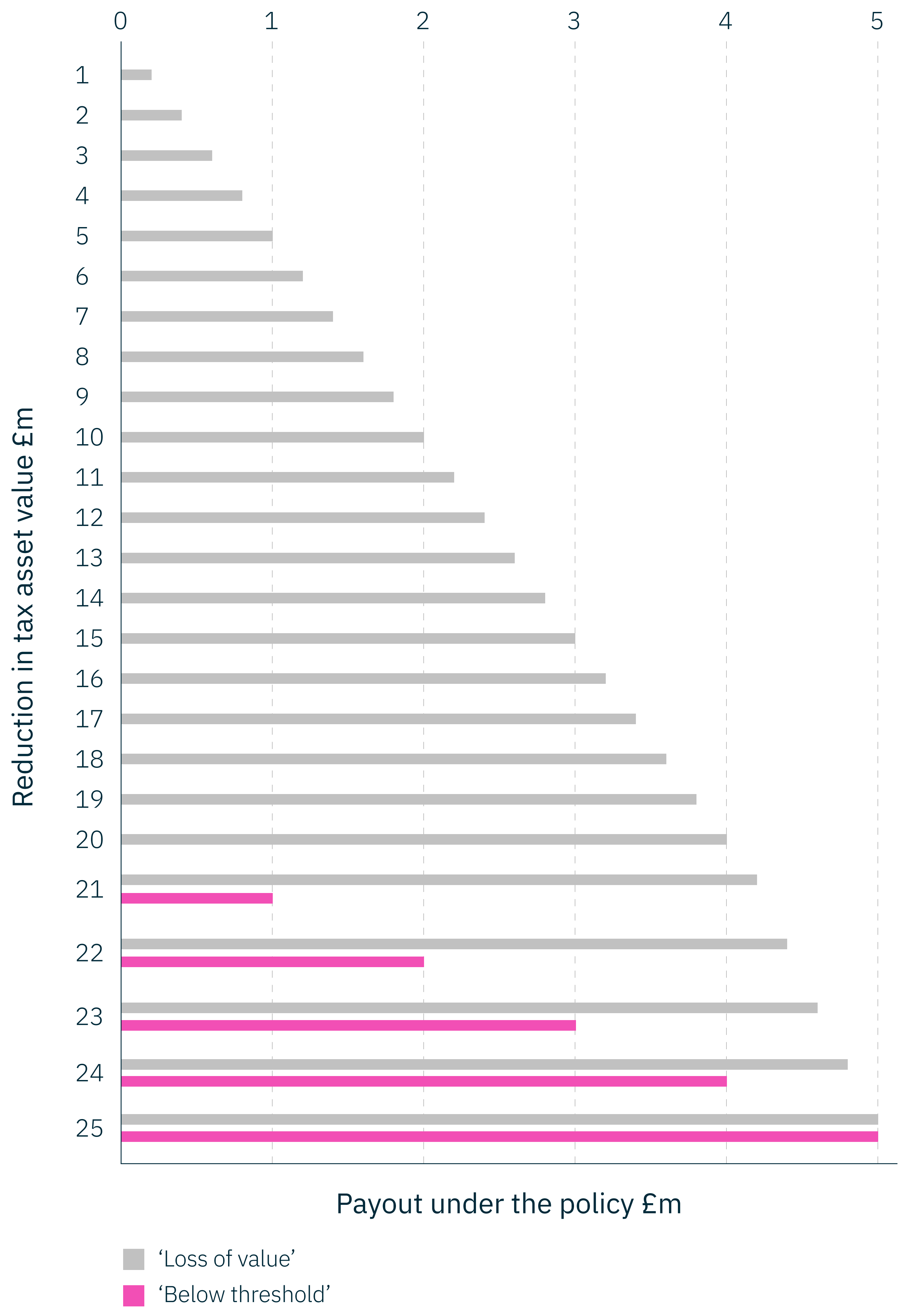
This is an upfront mechanism agreed with the insurer that would otherwise be achieved under a warranty claim under the SPA between the purchaser and seller where the purchaser is required to prove loss. It is therefore a more streamlined process providing certainty to the insured and the insurer upfront.

'Below threshold' cover

Here, the insurer only covers the loss of a tax asset below what has actually been paid. Using the previous example, the insurer would only pay out if the value of the tax asset was decreased to below the £5m amount paid.

The effect of this is that the discount paid for the tax asset effectively forms an excess for the insurer (80% excess in our example). Once the discount excess has been used, the insured can claim £1 for every £1 of tax asset lost (on an after tax basis). Extending the example, if the tax asset value was reduced to £4m following a successful tax authority challenge, the pay-out would be £1m (being the difference between the amount paid and the amount the tax asset is now worth).

As shown by the comparison model below, whilst both methods result in a £5m pay-out if the whole tax asset is lost, the 'loss of value' cover option is preferable from an insured's perspective if the tax asset value is reduced by a lower amount.



Due Diligence Requirements

Capital allowances

Historically, an insurer would only consider covering capital allowances if there was either a capital allowances report or highly robust due diligence.

Whilst this remains the gold standard, the position has changed significantly over the past couple of years. Due diligence providers have extensive data at their disposal to make comparable assessments of capital allowance allocation with similar assets and opine on the appropriateness of the position taken by a target group. This, coupled with tax authorities tending to approach challenges on the basis of statistical anomaly, gives insurers comfort to provide coverage.

Similarly, for UK targets, the enquiry window for HMRC challenge is based on the year of addition of the cost to the capital allowances pool (not the year of claim). Therefore, for some target groups, the risk can be significantly reduced depending on how long ago the relevant assets were acquired.

Losses

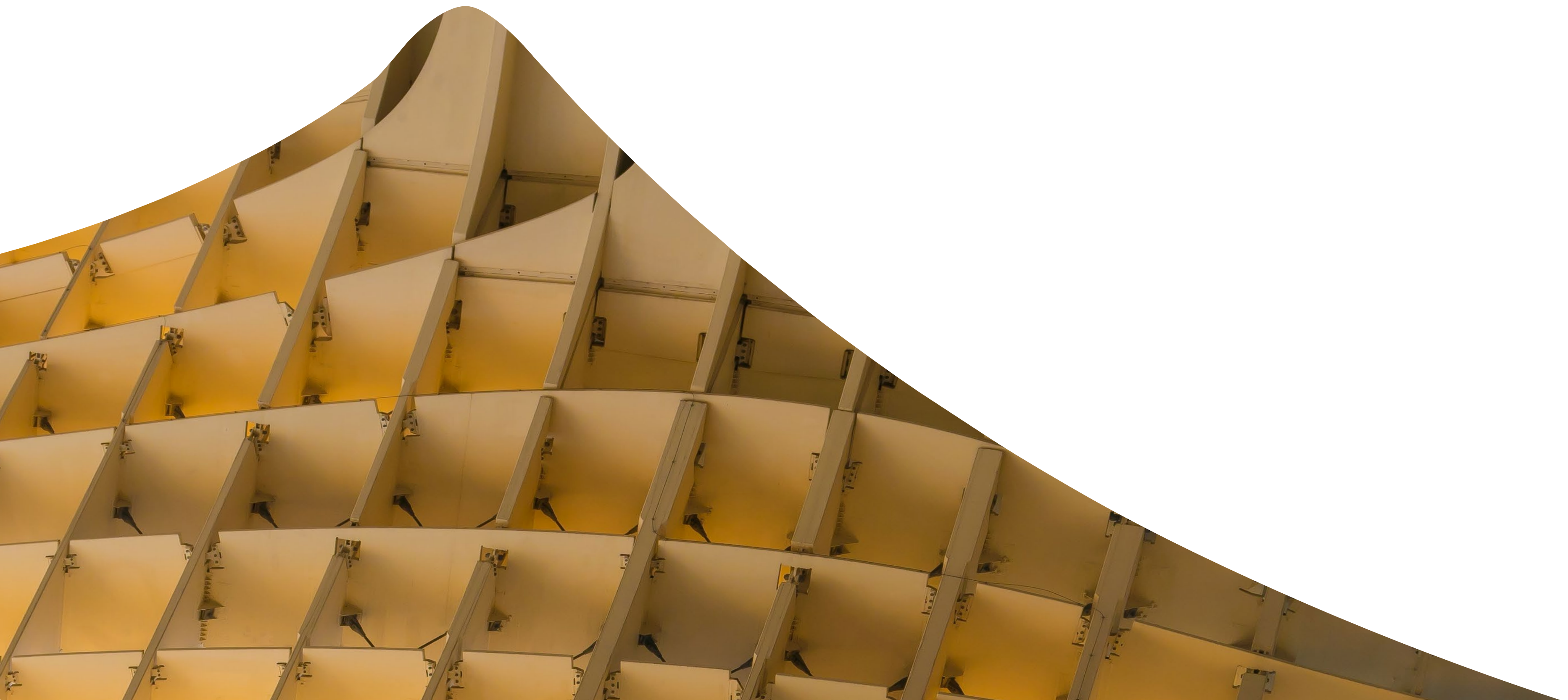
For losses, the key concern for an insurer would be the genesis of the tax loss. For example, an insurer would be normally more comfortable with tax losses arising from trading deficits as opposed to tax losses arising as a result of interest accruals/payments on intragroup debt, as the latter involves a transfer pricing assessment.

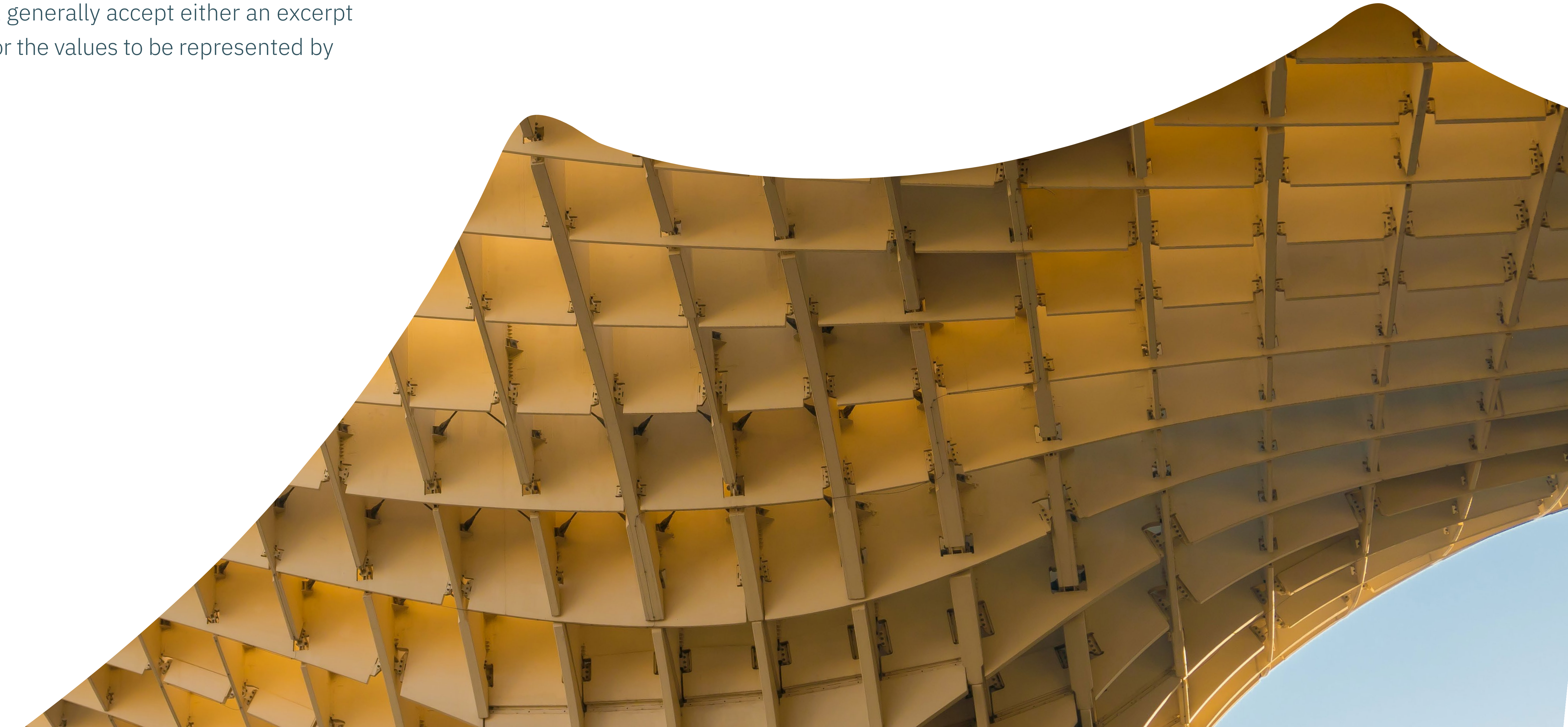
For UK targets, the enquiry window for tax losses is based on their year of creation and not their year of use so, as with capital allowances, insurers may be able to get comfortable that the risk is lower if the tax losses accrued some years ago.

Insurers will prefer to get access to a purchaser’s funding model so that they can understand how value is attributed to the tax assets for which cover is sought. Where there is commercial sensitivity around providing the model, insurers will generally accept either an excerpt relating just to the tax assets, or for the values to be represented by the insured in the W&I policy.

Key takeaways

- Where a seller or a purchaser is aware that value will be attributed to tax assets as part of a transaction, HWF can be engaged from an early stage to advise on:
  - scoping due diligence to ensure it meets the coverage requirements of insurers; and
  - the mechanism for obtaining coverage either through the transaction documents, synthetically or via a specific tax policy.
- Where a purchaser is intending to obtain coverage for tax assets, the funding model should reflect how any change in the value of such assets could affect the purchase price.





Key contacts

For further insights please visit hwfpartners.com.

Mark Parrett
Head of Tax
+44 (0)7966 638 235
mark.parrett@hwfpartners.com

Tim Dobbing
Associate Director, Tax
+44 (0)7858 422 677
tim.dobbing@hwfpartners.com

Rowley Higgs
Partner, Head of Infrastructure
+44 (0) 7977 125 420
rowley.higgs@hwfpartners.com

Yolanda Yong
Head of Renewables and Energy Transition
+44 (0) 7885 246 578
yolanda.yong@hwfpartners.com

In case you missed it, you can find our first piece on optimising the outcome in relation to due diligence for E&I transactions here.