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Specific tax insurance policies for known tax risks

Contrary to popular belief, specific tax insurance policies (hereafter referred to as tax policies) are not the only way to insure known tax risks. In certain instances, it may be appropriate to insure known tax risks under a warranty and indemnity (W&I) policy, particularly in the case of very low quantum, low risk, and uncomplicated tax issues.

This article provides insights into some of the advantages of a tax policy for insuring known tax risks, illustrated through a recent case study.

The Gold Standard

In our view, tax policies remain the "gold standard" for known tax risks. A tax policy is particularly advantageous when it comes to matters such as scope of coverage, identity of the insured, advance pay-outs, and flexibility. Each of these will be discussed in more detail below.

1. Scope of coverage

Certain types of tax risks, for example, transfer pricing, secondary tax liabilities, loss of tax assets, or matters under audit/litigation which are typically excluded under a W&I policy, could potentially be covered under a tax policy. For example, Marsh recently brokered a tax policy for a large self-employed/employee reclassification tax risk (a risk typically excluded under a W&I policy), which was under active audit by the relevant revenue service.

Unlike W&I policies, tax policies are not restricted to transaction-related tax risks. For example, tax risks identified in internal group restructurings, or the wind up of funds/companies, can effectively be insured under a tax policy.

In a transaction context, tax policies can also provide insurance cover for tax risks relating to the deal itself, as opposed to only the target entity. For example, tax risks relating to real estate transfer taxes, withholding tax on the purchase consideration, and capital gains tax (CGT) exposures for the seller, can potentially be covered.

2. Identity of the insured

In a tax policy, the insured can be the taxpayer entity or seller, rather than the buyer. This increases flexibility when it comes to the portability of the policy, i.e. for the policy to be transferred together with the taxpayer entity once this is sold or the insurer is being prepared for sale. Taking into account that tax policies are typically valid for seven years or longer, this could be significant.

Even if the buyer is the insured entity, the tax policy would still include a mechanism to facilitate portability, although this is obviously not as simple as merely having the taxpayer entity as the insured party.

It may be appropriate for a tax policy to be in the name of the seller, when deal-related tax risks for the seller are being insured (for example, CGT risks), or the seller requires a tax policy to back up a tax indemnity it provides to the buyer.

3. Accelerated payment terms

A particular feature of recent tax policies is that accelerated payment terms are often included. These may become very important in tax jurisdictions where the law provides for a so-called "advance tax payment" to be made, before a decision of the tax authority can be appealed. The tax policy may provide that an advance payment will be made under these circumstances, in order to ensure that the insured party is never out of pocket.

4. Flexibility

Due to the fact that tax policies are designed to address a particular known tax risk, such policies often have the flexibility to be tailored to the commercial requirements of the insured. This can be illustrated with reference to a recent case study:

- The insured was a company with significant tax losses, and it was their intention to set these off against future profits. However, in the UK the so-called major change in the nature or conduct of a trade (MCINOCOT) rules dictate that losses may be forfeited on a change of control, if there is a change in the nature of trade in the years post transaction.
- Since the insured was the subject of a transaction, and intended to make certain changes to its trade post transaction, a tax policy was structured around this risk, providing protection against the MCINOCOT rules being triggered on the future changes.
- In addition, a mechanism was established in the policy whereby non-specified bona fide future commercial actions, which may be relevant for the MCINOCOT test, can be brought within cover.

Such flexibility would, for example, be difficult to achieve in a W&I policy, which was designed with a different purpose in mind.

Tax policies, originally an offshoot of W&I policies, have evolved significantly over the past number of years into bespoke, tailor made insurance products for tax risks. They should be considered for all types of tax risks.

For more information please contact your usual Marsh representative.

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Marsh Specialty's Private Equity and Mergers and Acquisitions team supports the investment and M&A community to manage risk, create value, and accelerate growth. With over 200 professionals globally, the UK team consists of more than 60 colleagues from M&A, legal, and insurance backgrounds, and advises on over 800 transactions annually across the full spectrum of sectors, transaction sizes, and jurisdictions.