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Utilizing tax insurance beyond M&A

Tax insurance has traditionally been used by private equity funds and corporations to mitigate the risk associated with "known" tax issues discovered as part of the due diligence during mergers and acquisitions (M&A). But asset managers, hedge funds, family offices, and high-net-worth individuals are also looking to tax insurance to mitigate their tax-related risks outside of the M&A context.

As these taxpayers tend to have quite individualized and potentially unique needs, a more customized approach to tax insurance benefits these prospective insureds.

Marsh's team of tax insurance specialists within our Private Equity Mergers & Acquisitions (PEMA) Practice has the experience and knowledge to help you understand your potential tax risks, quantify their possible impact, and build a bespoke insurance program that addresses your specific risks. Our team consists of former investment bankers and tax advisors who bring critical expertise in capital markets and a proven track record in assisting organizations like yours.

Using tax insurance outside an M&A context

Tax insurance has most commonly been used in the M&A context to insure tax risks — such as pre-acquisition restructurings with specific tax consequences, or S corporation issues (often with basis step-ups) — for which a buyer is not indemnified. Sellers may also offer to provide tax insurance in lieu of indemnities.

Fund managers have become increasingly interested in using tax insurance to mitigate a number of risks, such as those associated with selling portfolio companies and other investments or managing tax risk for trading strategies. They are also using tax insurance as a balance sheet risk mitigation tool or to manage tax reserves, as the insurance may reduce and or potentially eliminate contingent tax liabilities.

Taxpayers should naturally consult with their auditors when considering the potential effects of tax insurance in conjunction with managing tax reserves for accounting and financial statement purposes.

Hedge funds and family offices

In the hedge fund space, tax insurance can help principals and limited partners in hedge funds to mitigate tax risks stemming from tax authority challenges that impact the fund's partners. Where partnership audit rules might disallow a "push-out" election, with the result that individuals who held a partnership position during a specific tax year are responsible for historical taxes even after their interest in the partnership has ended. Tax insurance can provide protection from those tax liabilities.

Tax insurance can potentially be used for a variety of tax-related exposures in the hedge fund space, including:

- Income characterization (that is, capital versus ordinary income treatment)
- Basis adjustments for assets
- Timing of recognition of gain in a restructuring

- Subpart F (deemed dividend) income
- Effectively connected income/permanent establishment
- Withholding tax issues (that is, tax treaty eligibility)

Family offices tend to face similar exposures as hedge funds. In addition to the protections mentioned above, tax insurance can provide family offices with coverage for financial losses resulting from tax risks throughout the asset lifecycle.

Tax insurance is typically triggered by specific events, such as internal restructurings, and provides protection for new risks or historical exposures. Tax insurance can also be used to address fund-level issues, such as issues impacting risk flow to new versus former limited partners.

Trusts, estates, and gifts

Similar to certain aspects of the family office asset manager, tax insurance in the trusts, estates, and gifts space is generally event-driven, often triggered by tax planning. Insurance coverage can provide protection for both new risks and historical exposures. For example, tax insurance can be used to mitigate the risk of a large potential downside exposure that would result from the Internal Revenue Service (IRS) or another taxing authority challenging a tax position taken in connection with tax planning, filing of tax returns, and/or setting up of grantor trusts.

Tax insurance can potentially assist in a range of situations, including:

- Tax restructuring due to family dynamics or error in an estate plan.
- Reformation of a marital trust that reduces a party's share and that portion will not constitute a taxable gift to the other beneficiaries under section 2501 of the Internal Revenue Code.
- Severance of a marital trust that will not affect the estate tax marital deduction claimed by the estate on IRS Form 706, the estate tax return.
- Generation-skipping transfer tax issues.
- When the tax basis is affected by appraisal risks or residency issues or where distribution from a marital trust for an individual's health, maintenance, and support will not be considered part of the commutation of the trust or treated as a disposition under section 2519 of the IRC.
- Commutation of a marital trust that will not adversely affect the estate tax material deduction taken by the estate on IRS Form 706.

While individual policy terms and conditions can vary, a tax insurance policy generally covers the tax liability for claims made at least seven years from the time the policy is bound, along with penalties, interest, and legal contest costs. Further, if a payment under the policy is taxable to the insured, the policy can include a feature to increase the payment to account for taxes owed as a result of the policy payout. Once in place, tax insurance can offer peace of mind that the insured tax positions are protected, even if the IRS or another tax authority successfully challenges the insured's tax position.

How Marsh can help

Our team of tax insurance specialists have the experience and knowledge to help you understand your potential tax liabilities and select the policy that meets your objectives. We understand that each taxpayer's circumstances are different, and we will work with you to design a bespoke program that is tailored to your potential risks.

While the placement of a tax insurance policy can be completed in as little as one to two weeks, more complex policies may require more time, depending on a number of factors, including the nature of the exposures to be insured.

Placement of a tax insurance policy begins with a discussion between a member of Marsh's PEMA team and you and your advisors, followed by an independent assessment of the tax risk by potential insurers. We can then negotiate the policy's terms with an insurer on your behalf and see that the proposed coverage structure meets your objectives.

Our team of tax insurance placement specialists can also help you prepare the information insurers require to assess the insurability of your tax position. Generally, this includes:

- A detailed description of your tax position and, if applicable, the proposed transaction structure, including a list of attorneys, accountants, and other outside experts involved.
- A description of the type, value, and timing of tax issues involved for each party to the transaction, including a computation or schedule of the tax benefits/potential loss involved.
- A copy of the final or draft tax opinion or tax memo that sets out the tax issues to be addressed, if available, and the advisor's level of comfort with respect to the issues.
- Relevant transaction documents, such as partnership agreements and tax indemnities.

Why Marsh

Marsh has been a trusted name in the transactional risk market for over twenty years. We work with clients and insurers to place billions of dollars of insurance limits every year. We also offer claims advocacy to assist you in pursuing recovery for covered losses.

Contacts

For more information about Marsh's tax insurance solutions, visit marsh.com, or contact your local Marsh representative.

Craig Schioppo
Managing Director
+1 212 345 6492
craig.schioppo@marsh.com

Mark McTigue
Managing Director
Tax Insurance Specialist
+1 646 283 2938
mark.mctigue@marsh.com

Patrick J. Browne Jr.
Senior Vice President
Tax Insurance Specialist
+1 202 256 9096
patrick.browne@marsh.com

Antony Joyce
Managing Director
Tax Insurance Specialist
+1 347 327 2690
antony.joyce@marsh.com

Alisha Soares
Senior Vice President
Tax Insurance Specialist
+1 917 207 0615
alisha.soares@marsh.com

Nika Antonikova
Senior Vice President
Tax Insurance Specialist
+1 760 672 9194
nika.antonikova@marsh.com

Kristy Balkwill
Senior Vice President
Tax Insurance Specialist
+1 416 371 4174
kristy.balkwill@marsh.com

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1166 Avenue of the Americas, New York 10036

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