The Use of Insurance to Mitigate Tax Exposure

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William Gallagher Associates specializes in Management Liability for publicly held companies. WGA is one the country's leading independent brokerage firms providing insurance brokerage, risk management, and employee benefit services to companies with complex risks.WGA has offices in Boston, MA; Princeton, NJ; Columbia, MD; Atlanta, GA; and Paris, France.

The reduction of Private Letter Rulings (PLRs) by the IRS in August 2003 has, among other things, led to a rediscovery of insurance as a way to move transactions that incorporate tax treatments that may not be totally opined or adjudicated by the IRS. Use of this product can mitigate a company's potential exposure to possible taxing authority investigation, reversal, tax, costs, penalties and interest.

For example, the exposure of not passing the Section 355 "business purpose" test with no PLR "net" to fall back on, could not only be expensive but even worse could prevent companies from moving forward with perfectly legitimate transactions where a gray area in the Tax Code exists or where the IRS has not litigated the issue. Without a ruling or reliable law, you either take the financial gamble or scrap the transaction. Isn't there another way?

While there are a number of circumstances that the policies could address, some common ones are:

- **Debt vs. Equity Determinations** – Characterization of an instrument as debt or equity is generally viewed by most taxing authorities as highly fact and circumstance based and not generally the subject of a PLR.

- **Tax-Free Spin-offs** – A company is spun off from its parent in a tax-free divestiture. A year later the spun off company receives a purchase offer from a company in the same business. Despite the fact that the target company and the potential purchaser have independent tax opinions from reputable counsel that a past tax free spin-off will not be jeopardized by the transaction, the financial impact to the purchaser, if the treatment is not received and approved, can be significant enough to kill or reduce the value of the deal.

- **Interconnection Agreements** – Addresses exposures surrounding the federal tax treatment of payments and transfers made to the owner of a transmission grid (usually a utility) in connection with the construction of facilities that allow independent power plants to supply electricity to their customers.

- **Placed in Service** – Addresses the concern that the IRS determines one or more of its assets has failed to be placed in service at a particular time or not at all. A company's exposure includes amortization and depreciation of assets, including Bonus Depreciation, and Sections 29 and 47 related assets.

- **Tax Credits** – Most common are the non-conventional fuels credit under Section 29 and the rehabilitation credit under Section 47 of the code.

- **Trade or Business** – For tax related exposures faced by foreign companies when investing in investment, venture or hedge funds with US based advisors or when engaging in a limited transaction with the risk of being characterized as being "engaged in US trade of business" (ETB).

- **Section 351** – In a purchase and sale, 351 provides that there is no gain or loss if property is transferred to a corporation by one or more persons solely in exchange for stock and "immediately thereafter" such persons are in "control" of the corporation. "Immediately thereafter" is not defined.

Typical Policies

The policies are highly manuscripted to fit the specific deal. However, there are many shared common attributes.

"Claims Made"

All policies are written on a "claims made" basis. A claim must be made by the insured to the insurer within the policy term and according to the reporting requirements. The policy term is most often several years, but the term should always reflect the statute of limitations of an IRS investigation of the subject insured tax treatment, which is usually six years.

What is covered?

In the broadest sense, the intent is to cover the tax itself with any penalties and interest, along with corresponding defense costs. However, additional consideration should be given to consequential losses, such as the loss of future net operating losses (NOLs) as a result of an adverse ruling on the subject insured tax treatment.

Many policies also provide coverage for the "gross up" or additional taxes owed by the insured as a result of a loss payment under the policy.

Limit of Liability – "How much should we buy?"

The amount of limits purchased depends largely on the down side of a total bust up by the taxing authority of any particular tax treatment. It is not always necessary to insure for the entire amount. Insureds should work with their broker to ascertain potential tax, interest, penalties and likely defense costs.

Also affecting the amount of limits is when one feels a particular matter, if brought, might be settled, i.e. before final adjudication or upon appeal. This will have a direct effect on the defense costs involved.

A decision can then be made as to how much limit to buy based upon what the company can incur without doing irreparable harm to the company's financials and future operating ability. The Insured's tax professionals should always be involved in the determination of proper limits.

Pricing of the Premium

Pricing is generally a function of "rate on line"; that is to say, a certain percentage per million of limits purchased. Current percentages range around 6% to 12%, depending upon the complexity of the tax issue and the comfort the underwriter has with the Insured's position. For instance, if an opinion exists, a "will" opinion will command a lower rate than a "more likely than not" opinion.

Occasionally it may become necessary to involve several carriers to build a total program. Many carriers have capacity limits that will not permit them to commit more than a certain amount to any single transaction. In those cases, the broker will need to work with several companies to secure the necessary limits required.

Retentions and Co-Insurance

Retentions (aka deductibles) are always subject to negotiations. In some cases a carrier might also impose a coinsurance clause that requires the insured to share a percentage of loss above the retention. In most circumstances where coinsurance is imposed, the insured may be required to pay 5% to 15% of any amount above the retention.

Like pricing, both retentions and coinsurance are driven by the complexity of the tax treatment, limits sought and the insurance company's guidelines.

Exclusions

The policies are usually very broad with typically few exclusions. Standard ones include:

- A change in the tax law (other than a retrospective change)
- An Insured taking any action that is inconsistent with the subject tax treatment.
- Any conduct or action that is the basis of an Adverse Conduct Determination
- No payment to the benefit of the insured other than as a result of a Loss from the covered tax treatment.
- Tax liability other than Federal, State or Local.

Representations

Unlike many other forms of insurance, there is no application. Rather, the insurance company relies upon the representations given to the tax professional by the Insured in addition to further representations given to the carrier by the insured with the aid of their tax professionals.

Some policies actually add policy language that make these representations part of the policy. Specifically, they are facts relied upon by the underwriters in issuing the policy. Breach of these representations and/or covenants can nullify or restrict coverage.

The Non-Binding Indication

The underwriting process is quite different from most insurance polices.

Initially, consult a broker who has experience with the product and possesses knowledge of the insurance companies who offer this highly specialized coverage. Carriers are different in their approach to the exposure and the type and size of deals they are willing to consider. Some carriers perform their own internal legal review while others retain outside law firms to advise them during the review.

A brief written outline of the tax treatment is usually enough for the broker to determine which companies are likely to underwrite the risk and which ones will not. The carrier may request further documentation but

at this point, should issue a non-binding indication of the limits it will commit, pricing and retentions, along with a sample insurance policy. The insurance company will likely ask for an underwriting fee to prepare a bind-able quote.

Underwriting Fees

It is common practice for insurance carriers to charge an underwriting fee. These fees are always negotiable and should represent actual costs incurred by the carrier to perform it's legal research and due diligence.

One should negotiate the amount of the fee, considering whether it will be applied to the premium if the policy is bound and if it will be refundable in whole or part should the carrier not offer terms.

A fee should only be paid after receipt and review of the non-binding indication and a sample policy.

The Underwriting Process

Once the fee is paid, the underwriting process begins in earnest. Unlike the process associated with other lines of insurance, there is a great deal of interaction directly between the Insurers and the Insured, including their accountants and attorneys. The entire process not only includes discussions of the tax treatment, but also specific policy provisions and their applicability to each tax treatment scenario. The knowledgeable broker should act as the advocate and negotiator for the Insured while advising them and facilitating the process and flow of information.

Claims

Claims are generally handled much like directors' and officers' claims with the major difference being that the "plaintiff" is the IRS rather than a group of shareholders.

Notice is given to the carrier(s) who usually engages an outside law firm to monitor the case and associate with whomever the insured has chosen to defend against the taxing authority.

Most carriers agree to reimburse defense costs as they are incurred above the retention and subject to any coinsurance. However, it is key, when negotiating the policy language, that this provision be added if it does not exist. Otherwise, the Insured could be saddled with enormous out of pocket expenses until the claim is resolved which could take months or even years.

Conclusion

After conducting a public hearing on the issue of tax opinion insurance in 2003, the IRS and Treasury Department removed tax insurance from its list of reportable transactions.

One caution is in order, however. These products are not to be used to support and hedge creative tax schemes constructed to avoid paying taxes. Knowledgeable brokers and underwriters will reject any effort to insure tax constructs intended to avoid paying taxes otherwise owed.

On the other hand, when properly used in support of legitimate business transactions that have tax implications that are not well defined, they are an effective tool in mitigating possible exposures.

For more information on Management Liability for publicly held companies and Transaction Facilitation Products such as Tax Opinion Liability and Representations & Warranties Insurance contact your Account Executive at William Gallagher Associates.