Use of Tax Insurance in Mergers and Acquisitions

In most M&A transactions, tax forms an integral part of the due diligence (**DD**) conducted. The tax DD is meant to allow the buyer to attain a more in-depth understanding of the tax risk profile and liabilities associated with the target. Tax risks and liabilities identified during such a DD could be accounted for by way of specific indemnities in the Share Purchase Agreement (**SPA**) or a purchase price adjustment. However, there are many cases where the buyer and seller are not able to agree how to allocate or value a tax risk and this can be an obstacle to get the deal across the line. The Asian M&A community are increasingly seeing the potential of tax insurance to remove such an obstacle.

What is tax insurance?

Tax rules are famously complex, especially when business operations span multiple jurisdictions. Even with the best expert advice, companies often need to make good-faith judgments about how the rules apply to their business operations. Tax authorities might have a different judgment about how the very same rules apply to the very same business operations and challenge a tax position taken by a company. This results in uncertainties which often cover multiple financial years and involve significant amounts. Most corporates prefer to avoid such uncertainties. This is why tax insurance was developed.

Tax insurance helps to reduce or eliminate the exposure to an identified risk of a “loss” arising from a successful challenge by a tax authority to the expected tax treatment of a proposed or historic transaction. A covered “loss” not only includes the taxes due but also associated defense costs, interest, non-criminal penalties and gross-up for payments made under the tax insurance policy.

What are the benefits in an M&A context?

Like all types of insurance, the main benefit of tax insurance is that it functions as a risk transfer mechanism under which identified (tax) risks are transferred from a taxpayer to an insurer in a cost-effective manner. This provides certainty to the parties involved and eliminates financial contingencies.

In M&A transactions, uncertainty surrounding identified tax issues can be an obstacle to strategic planning and getting a deal across the line. Tax Insurance can remove a specific tax concern from a transaction that might otherwise be a deal-breaker. Let’s look at an example to make this clearer:

*Company A (**Buyer**) is a multinational enterprise operating in the fashion industry and looking to expand its product portfolio with a high-quality jeans line. Company B (**Seller**) is one of the Buyer’s competitors and looking to divest its Jeans Division, which is a stand-alone part of the business. The Buyer approaches the Seller to commence due diligence and negotiations.*

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*A key finding in the tax due diligence report is the risk that, due to the anticipated change in ownership, the Net Operating Losses (**NOLs**) of the Jeans Division are no longer available to offset against future profits. The probability of the risk is low, but the severity is high, and this is a deal breaker for the Buyer. For the Seller to convince the Buyer to proceed with the deal a tax insurance policy is put in place, which facilitates a cost-effective transfer of the NOLs risk to an insurer.*

Tax Insurance can be a welcome alternative to lock up cash in an escrow account as security for specific tax indemnities given. Let's again look at an example:

*In 2013, Company A (**Seller**), tax resident in jurisdiction A, acquired a 100% stake in Best Company B (**Target**). The Target is a tax resident in jurisdiction B. In 2020, the Seller wishes to exit the Target and, Company C, a large conglomerate (**Buyer**) is interested. The Buyer commences due diligence and negotiations with the Seller follow. Based on the anticipated purchase price, the Seller would realize a significant capital gain. Under the domestic laws of jurisdiction B, any capital gains are taxed with Capital Gains Tax (**CGT**) unless the recipient can claim an exemption under an applicable tax treaty. Unfortunately, domestic laws and the tax treaty are not entirely clear about the circumstances under which Seller can claim the exemption and the calculation of the exempted taxes. Domestic laws further require that the Buyer withholds CGT from the purchase price payable to the Seller. Although the Seller makes a good-faith determination of the amount of CGT to be withheld by the Buyer, the Buyer does not want to take on the risk of any underpayment of CGT and required an indemnity from the Seller, with the full amount of CGT held in escrow as security. The escrow amount represents a significant amount of cash locked up for 10 years, preventing the Seller from investing this cash elsewhere. To avoid this inefficient situation, Seller buys a tax insurance policy that covers the Buyer for any losses resulting from an underpayment of CGT, allowing the Buyer to release the escrow requirement.*

What type of tax risks are insurable?

Not every tax risk is insurable. In general, insurers prefer to underwrite tax risks with a low to medium probability of materializing. There is an increasing appetite to underwrite Asian tax risks and risks of many types are considered, ranging from typical M&A related issues such as capital gains tax and dividend withholding tax to non-transactions issues such as the tax neutrality of an internal restructuring and transfer pricing. Insurers have little appetite for tax risks relating to tax avoidance/contrived structures.

To successfully insure a tax risk, it is crucial that there is a sound legal basis for the tax position (to be) taken. Ideally, that legal basis is laid down in an advice or opinion from a reputable tax advisory or law firm, detailing the merits of the risk and the chances of the tax authorities being successful in case they challenge the tax position (to be) taken. No insurance can be obtained based only on risk of detection by the tax authorities.

Process and terms

The process of putting a tax insurance policy in place normally only takes a few weeks and is facilitated by an insurance broker who ensures that parties obtain the best possible terms and cover from insurers.

The premium for a tax insurance policy is a percentage of the sum insured (which covers tax, interest, non-criminal penalties and defence cost) and is paid post inception, as a one-time only premium for a multi-year policy. Pricing primarily depends on the nature of the risk and the strength of the legal position while factors such as market conditions, jurisdiction and size of risk also play a role.

The policy period for tax insurance is normally aligned with the period during which the tax authority can challenge the position taken by the taxpayer ("statute of limitation"). In practice, policy periods are up to 7 years and in some cases up to 10 years.

Conclusion

Tax insurance helps to reduce or eliminate the exposure to an identified risk of a "loss" arising from a successful challenge by a tax authority to the expected tax treatment of a proposed or historic transaction. In M&A transactions, tax insurance can be used as a cost-efficient tool to get a deal across the line and/or avoid the inefficient use of escrow accounts. Combined with an increasing appetite of insurers for underwriting Asia M&A tax risk, it is expected that demand for tax insurance will rapidly grow in the Asia.

We hope you enjoyed the read.

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