TAX INSURANCE CAN MAKE THE INSURED WHOLE IN THE EVENT OF A SUCCESSFUL CHALLENGE BY A TAXING AUTHORITY

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TAX **INSURANCE**

PROVIDING TAX CERTAINTY

CAC Specialty's Tax Insurance Practice, comprised of seasoned tax attorneys and former tax insurance underwriters, combines deep tax technical expertise, industry experience, and business acumen to craft innovative and unique tax insurance solutions so any client can quickly transfer the risk of the unanticipated and detrimental consequences of a successful challenge by a taxing authority—creating more certainty for sponsors, corporations and stakeholders.

OVERVIEW OF TAX INSURANCE

Tax insurance is a risk management tool protecting against tax loss arising from one or more transactions, investments, or events. It is designed to make the insured whole in the event of a successful challenge by a taxing authority, and can cover loss for additional taxes, interest and penalties, claim expenses in defense of the covered tax position, and the amount by which the insured's taxes are increased as result of the receipt of insurance proceeds under the policy (i.e., "gross-up").

Tax insurance is akin to receiving a private letter ruling ("PLR") from the taxing authority on the insured tax position. However, unlike a PLR, tax insurance can typically be purchased within 2 weeks—not months or years.

WE ARE DIFFERENT

Our team consists of dedicated, experienced corporate tax attorneys (accounting firm, law firm, and Fortune 20 experience) and former tax insurance underwriters.

- Attorneys capable of handling technical tax issues
- Equipped to guide the insurance market to understand difficult tax risks
- Devoted to client service and advising clients through every step of the underwriting process, including policy negotiations
- Ready to collaborate with the insurance market to craft insurance solutions

Tax Insurance Market: Quick Facts

MARKETS
with at least $50 million of capacity

MARKETS
able to participate in any program

BILLION
of total capacity on any U.S. tax program

TAX INSURANCE FOR M&A TRANSACTIONS

Tax insurance can be used to reduce or eliminate the risk of historic tax positions taken by the target entity, as well as tax issues arising from the transaction itself. Tax insurance removes the identified tax risk from a deal by transferring it to the insurer, providing certainty and flexibility.

NOT R&W INSURANCE

While known tax issues are excluded from coverage under a traditional representation and warranty ("R&W") insurance policy, tax insurance complements a R&W insurance policy by providing coverage for such tax issues.

Tax insurance can be used as a competitive tool by either the buyer or seller as part of the M&A process. It may be purchased by the buyer to make its bid more competitive or by the seller as part of its preparation for sale (thus, removing the tax issue from negotiations with bidders).

BENEFITS

- Facilitates deal negotiations by reducing or eliminating the need for tax indemnities and escrows for identified tax issues
- Facilitates financing and investment decision making
- Enables a clean exit by eliminating a long-tail contingent exposure
- Provides purchase-price certainty by removing an identified tax exposure
- Secures future tax benefits to be realized from the transaction
- Offers liquidity and avoids the negative cash flow arising from a tax liability

INSURABLE TAX RISKS

There are three areas of insurable risks in M&A transactions where tax insurance can be utilized. First, tax insurance can be used to reduce or eliminate the tax risk related to historic tax positions taken by the target on seller's watch (e.g., debt v. equity treatment, deduction v. capitalization of expenses, or transfer pricing). Second, tax insurance can be used to address tax issues arising from the transaction itself (e.g., any pre-closing restructuring, treatment of the transaction as tax-free reorganization, or availability of a tax basis step-up). Third, tax insurance can be used to insure the historic tax treatment of the target entity itself (e.g., S corporation status, REIT status, or MLP status).

TAX INSURANCE FOR BALANCE SHEET PROTECTION

Tax insurance can be used as a risk management tool protecting against contingent tax exposures even when there is no M&A transaction.

TAX POSITIONS

Tax insurance can be used to protect companies against contingent tax exposures in the ordinary course of business. The tax code is complex, and, despite receiving tax advice from an attorney or accountant, the proper tax treatment of a transaction or event may be uncertain—either because there is no clear guidance on the tax issue or the fact pattern is unique, or because the tax position requires a degree of judgment (e.g., valuations) or an evaluation of intent (e.g., business purpose). If the IRS disagrees with the company's tax position, the company may owe unanticipated and potentially significant additional taxes, interest, and penalties.

Tax insurance removes the tax uncertainty from any contemplated tax planning (e.g., internal reorganizations or restructurings or transactions with shareholders) as well as any internal transactions or events that are part of a company's ongoing business operations (e.g., transfer pricing, accounting methodology, R&D credits, and carryback of NOLs). In each of these instances, tax insurance allows companies to execute these transactions with complete tax certainty, and may be purchased either before or after the tax position is reported on the tax return.

In many instances, tax insurance can be used as a substitute for a PLR, which may either be unavailable because the IRS will not rule on the issue or because it simply takes too much time to receive a response from the IRS. Tax insurance provides companies with the same level of comfort as a PLR and can be obtained in approximately 2 weeks.

In certain circumstances, tax insurance may even be purchased to insure the outcome of a pending tax audit of a tax position—meaning the tax position has already been reported on the company's tax return and is now being reviewed or challenged by the taxing authority.

TAX RETURNS

Tax insurance can be used to insure the U.S. federal income tax return of a corporation or partnership filed or to be filed with the IRS for any given tax year. Unlike typical tax insurance, tax return insurance insures all tax positions taken by the taxpayer on its U.S. federal income tax return.

BENEFITS

- Offers liquidity while avoiding the negative cash flow arising from a tax liability
- Eliminates or reduces the tax risk (equity, income, and cash-flow impairment) that may not have been fully reserved in financial disclosures
- Provides certainty to deferred tax assets (e.g., NOLs, R&D credits, foreign tax credits) that are difficult to evaluate and monetize
- Facilitates redemptions, liquidations or dissolutions by providing tax certainty for historic tax positions
- Bolsters the conclusions in a tax opinion prepared by the taxpayer's tax adviser
- Provides a solution to the new IRS partnership audit rules for partnerships with partner turnover (i.e., avoids having to choose whether the tax should be collected from the current partners or the partners in the audited tax year)

TAX INSURANCE FOR FACILITATING TAX EQUITY TRANSACTIONS

OVERVIEW

Tax credits, which can be used to reduce (on a dollar-for-dollar basis) a taxpayer's income tax liability, incentivize investment in socially desirable ventures, including energy, low-income housing, and rehabilitation projects.

Tax insurance can be used as a risk management tool to protect a tax equity investor against tax loss arising from an investment in the underlying project. Rev. Proc. 2014-12 and 2020-12 encourage the use of tax insurance.

Tax insurance can also be used as a strategic financial tool to protect a back-leverage lender who is at risk of a "cash sweep" (i.e., cash proceeds that would otherwise be allocable to the sponsor are used to pay the sponsor's tax indemnity obligation to the tax equity investor).

KEY TAX RISKS

- Will the investment structure (e.g., partnership flip, inverted lease, sale-leaseback transaction) be respected (e.g., partnership and partner status, allocation of the tax credits, ownership of the energy property)?
- Will the tax credits claimed be allowed in full (e.g., classification as energy property, allocation of basis to energy property, begun construction risk, placed in service risk)?
- Will the tax credits, properly taken, nonetheless be recaptured?
- Will the tax credits be denied as a result of a retroactive change in law?

A hybrid R&W and tax insurance policy is also available to insure the tax equity investor of any breach of the representations and warranties made by the sponsor under the transaction agreements.

BENEFITS

- Offers liquidity while avoiding the negative cash flow arising from a tax liability
- Secures tax benefits to be realized from the investment
- Facilitates financing and investment decision making
- Provides purchase-price certainty by removing potential tax risk

COMMON INSURABLE RISKS

Subchapter S corporation status and section 338(h)(10) election	Deductibility of expenses versus capitalization
Real Estate Investment Trust ("REIT") status (including all other representations and warranties)	Subpart F income
Spin-off, reorganization, and recapitalization	Foreign tax credits
Transactions with shareholders or partners (e.g., distributions, contributions, sales)	Foreign Investment in Real Property Tax Act (FIRPTA)
Transfer pricing	Nexus and permanent establishment
Historic net operating losses and any section 382 limitations	Tax treaty (including limitation on benefits)
Fair market value and tax basis	Excessive compensation and deferred compensation (e.g., 409A, 280G, 83)
Tax credits (e.g., investment, tax credits, production tax credits, rehabilitation tax credits)	Employee versus independent contractor
Debt versus equity analysis	Sales and use tax
Worthless stock deduction and bad debt deduction	Transfer Tax
Capital versus ordinary income treatment	Accounting methodology

FREQUENTLY ASKED QUESTIONS

Can any tax position be insured? Generally, any tax position that is at a comfort level of at least "more likely than not" and is not a "reportable transaction" can be insured. There is approximately $1.5B of capacity for any U.S. tax insurance placement. International tax insurance placements can be obtained for most countries, though certain jurisdictions may be harder to place than others. If you are interested in inquiring about a specific jurisdiction, please contact us.

What is covered under the policy? Tax insurance is intended to make the insured whole if the covered tax position is successfully challenged by the taxing authority—including payment of additional taxes, interest and penalties, claim expenses in defense of the covered tax position, and the amount by which the insured's taxes are increased as result of the receipt of insurance proceeds under the policy (i.e., "gross-up").

Is a tax opinion required? No. While a tax opinion is helpful, due diligence reports or memos setting forth the applicable tax analysis will generally provide the underwriter with sufficient information to underwrite the risk transfer.

How long does it take to bind a policy? Unlike a PLR, which can take months or even years to obtain, if the IRS will rule at all, a policy can typically be bound in 2 weeks. This timeline is particularly beneficial in the M&A context.

How long is the policy good for? Typically, the policy period is 7 years, but can be extended up to 15 years in certain circumstances. Since the policy is a claims-made policy, a claim only needs to be made within the policy period—it does not need to be resolved with the taxing authority within the policy period. For example, if the insured notifies the insurer that the covered tax position is under audit during the policy period, the insured will be covered even if the audit is resolved beyond the policy period.

What are the ratings of the participating insurance companies? All insurance carriers are at least A rated by A.M. Best and S&P.

What are the typical policy exclusions? Generally, the policy will not pay loss arising from the following limited exclusions: (1) inconsistent filing positions, (2) material misrepresentations made by the insured, and (3) change in law (unless specifically identified as a covered tax position).

How much tax insurance has been purchased? Multiple billions of dollars of limits of tax insurance have been purchased, from small companies to Fortune 100 companies.

Do I have to report the policy to the IRS? No. The insured has no obligation to report the tax insurance policy to the IRS solely as a result of obtaining the insurance.

If I get tax insurance, how does an audit work? The insured has a duty to defend any challenge to the covered tax position and the insurer will have reasonable participation rights. Generally, the insured cannot settle an audit without the consent of the insurer, which will not be unreasonably withheld, delayed, or conditioned.

Does tax insurance mitigate the need for an ASC-740 reserve? It depends. We are happy to discuss with you and your accountants our experience with ASC-740-10 and tax insurance.

TAX INSURANCE TEAM

JORDAN TAMCHIN

Senior Vice President and
Tax Insurance Practice Leader

Direct: 561-715-5043
jordan.tamchin@cacspecialty.com

Years of Experience: 11

Jordan B. Tamchin, Esq. is a Senior Vice President and leader of the Tax Insurance Practice. Jordan specializes in delivering innovative and unique insurance solutions for the most complex tax risks. He brings technical tax expertise, market experience and business acumen. Jordan is a leader in the tax insurance industry and continues to play an instrumental role in its dynamic growth and acceptance among insurance carriers, corporations and private equity funds.

Prior to joining CAC Specialty, Jordan was Vice President, Tax Insurance Counsel for Concord Specialty Risk, a part of Ryan Specialty Group's RSG Underwriting Managers, where he underwrote a wide range of tax risks for corporations and private equity funds. Prior to that, Jordan was a tax attorney at Simpson Thacher & Bartlett LLP, where he represented multinational corporations and private equity funds on the tax aspects of mergers and acquisitions, joint ventures, spin-offs, and capital market transactions. In addition, Jordan was a tax adviser in the M&A tax group at PricewaterhouseCoopers LLP, where he performed tax due diligence and structuring on behalf of his private equity and corporate clients.

Jordan graduated with honors from the University of Michigan – Ann Arbor where he received a Bachelor of Arts degree in economics and psychology. Jordan received his Juris Doctorate and Master of Laws in Taxation from New York Law School, where he graduated cum laude.

MATT MOVAFAGHI

Senior Vice President

Direct: 415-565-9777
matt.movafaghi@cacspecialty.com

Years of Experience: 11

Matt is a Senior Vice President in the Tax Insurance Practice at CAC Specialty. Matt specializes in providing multinational corporations unparalleled insurance solutions for complicated tax risks. He is excited to bring his in-house corporate tax experience, and to contribute to the expansion and recognition of the use of tax insurance in the insurance market.

Prior to joining CAC, Matt was Senior Tax Counsel for Chevron Corporation, where he provided sophisticated tax planning for Chevron's global organization. He held various positions of increasing responsibility, including tax planning for global manufacturing and refining, global lubricants, marine lubricants, and technology marketing. Matt was also responsible for tax planning for Chevron's Africa and Middle East upstream and downstream operations, which include operations in Angola, South Africa, Kuwait, UAE, Qatar, Bahrain, Saudi Arabia, and Iraq. Before Chevron, Matt was a tax attorney at Willkie Farr & Gallagher, LLP, where he represented corporations, private equity funds, and investment funds in connection with the domestic and international tax-related aspects of transactional matters, including taxable and tax-free mergers and acquisitions, investments, and partnerships.

Matt graduated from Stanford University where he received a Bachelor of Science Degree in Computer Science. Matt received his Juris Doctorate from the University of Texas School of Law and a Master of Laws in Taxation from New York University Law School.

TAX INSURANCE CASE STUDIES

S CORPORATION STATUS AND SECTION 338(H)(10) ELECTION

Issue: A fortune 500, publicly traded company ("Buyer") sought to acquire a target entity ("Target") that made an election to be treated as an S corporation for U.S federal income tax purposes. During tax due diligence, Buyer's tax adviser discovered that one of the trusts was not a permissible S corporation shareholder of Target. If the S corporation status of Target was terminated, this would result in Target being treated as a C corporation and subject to corporate level tax for all open tax years. Moreover, if the S corporation status of Target was terminated, Buyer would not be able to make a "section 338(h)(10) election" to step-up the tax basis of Target's assets and benefit from tax depreciation and amortization deductions post-closing. The tax exposure was material, especially in relation to the purchase price.

Solution: Target secured a tax insurance policy for the benefit of Buyer with limits of $100 million insuring against any tax loss resulting from the failure of the target to be treated as a valid S corporation, which included any tax loss for all historic tax years as well as any tax loss resulting from inability to make the section 338(h)(10) election. The policy allayed any potential tax loss resulting from the failure of the trust to be a permissible S corporation shareholder allowing the parties to swiftly and confidently close the transaction.

REIT R&W AND TAX INSURANCE

Issue: A private equity fund was seeking to acquire a portfolio of real estate assets which were held in more than 25 separate real estate investment trusts ("REITs"). The seller was unwilling to provide an indemnification for any breach of the representations and warranties under the purchase agreement, and the potential tax exposure related to the target entities' REIT qualification exceeded more than 30% of the enterprise value.

Solution: The buyer secured a hybrid REIT R&W and tax insurance policy to insure against any breach of the representations and warranties made by the seller in the purchase agreement, including tax representations related to the REIT status. This policy, with limits of $300 million, allowed the transaction to close.

HISTORIC NET OPERATING LOSSES AND OWNERSHIP CHANGES

Issue: A corporate buyer ("Buyer") agreed to pay additional purchase price consideration because the corporate target ("Target") had material net operating losses ("NOLs") that could benefit Buyer post-closing. Sellers provided documentation to support the quantity of the Target's NOLs. In addition, while no section 382 analysis was performed, the sellers provided documentation to support that the Target had not previously experienced an ownership change, which would otherwise significantly limit Buyer's ability to utilize the NOLs post-closing. Notwithstanding this documentation, Buyer wanted certainty regarding the amount and availability of Target's NOLs to be used in the post-closing period.

Solution: Buyer obtained a tax insurance policy with limits of $50 million for any tax loss resulting from any successful challenge by the taxing authority of the amount of Target's NOLs and the availability of such NOLs to be used in the post-closing period. Buyer not only insured the ability to use the NOLs (thereby, locking in the commercial value of the NOLs), but also any tax losses that would arise in the event of a successful challenge by the taxing authority.

TAX INSURANCE CASE STUDIES

PRE-CLOSING RESTRUCTURING

Issue: A private equity fund was interested in acquiring the shares of a global manufacturing company but, for certain business purposes, did not want to acquire certain assets held by the target. Prior to closing the transaction, the target distributed the unwanted assets to its shareholders, which resulted in taxable gain to the target. While the target received a third-party appraisal to justify the fair market value of the unwanted assets, the buyer did not want to inherit any potential tax exposure in the event the IRS challenged either the fair market value or tax basis of the unwanted assets.

Solution: To avoid a hanging indemnification obligation, the buyer agreed to purchase a tax insurance policy with limits of $400 million insuring that the amount of gain recognized by the target as a result of the distribution of assets to the shareholders would be respected by the taxing authorities.

TRANSFER PRICING – MITIGATE ASC-740 RESERVE IMPACT

Issue: A multinational company engaged a big-four accounting firm to perform a transfer pricing study of its U.S.-foreign intercompany transactions to determine whether the transactions were conducted at arms-length. The transactions included interest from intercompany financing, profit margins, and royalties for use of intangibles. The company faced a potential requirement to post an ASC-740 reserve for financial accounting purposes for potential tax liabilities as a result of the uncertainty associated with the transfer pricing.

Solution: The company purchased a tax insurance policy with limits of $25 million for any tax loss resulting from any successful challenge by the IRS, which mitigated the impact of an ASC-740 reserve.

TAX RETURN INSURANCE

Issue: A start-up technology company was seeking additional rounds of investment from potential investors. One of the investors placed significant value on the company's NOLs and R&D credits, and wanted certainty in the availability of such tax attributes.

Solution: In order to facilitate the investment and monetize the deferred tax assets, the company purchased a tax return insurance policy with limits of $25 million insuring its U.S. federal income tax returns for the prior 2 tax years.

TAX INSURANCE CASE STUDIES

INVESTMENT TAX CREDITS (ITCs)

Issue: An investor sought to make a tax equity investment in a project company that owned a utility scale renewable energy project. As a condition to such investment, the tax equity investor required the sponsor of the project to provide an indemnity against any tax loss resulting from the failure of the tax basis of the energy property to be respected by the IRS, but the sponsor lacked the capital and appetite to stand behind a full indemnity.

Solution: In order to facilitate the investment without the sponsor itself bearing financial responsibility for the indemnity, the sponsor purchased a tax insurance policy for the benefit of the tax equity investor to backstop the agreed-to indemnity with limits of $90 million.

PRODUCTION TAX CREDITS (PTCs)

Issue: A tax equity investor was seeking to invest in a wind farm, which would generate significant PTCs. In order to benefit from the full amount of the PTCs, construction of the wind farm had to begin in 2016. The determination of when a project has begun construction in this context requires a facts and circumstances analysis that inherently involves a level of risk with substantial stakes; the failure of the wind farm to have begun construction in 2016 would have resulted in a material reduction in the PTCs. While the developer was willing to provide representations that the construction on the wind farm began in 2016, it came with a limited indemnification providing little actual make-whole recourse for the tax equity investor.

Solution: The parties purchased a tax insurance policy with limits of $425 million in order to secure the tax equity investor's projected tax benefit from its investment in the wind farm. The tax insurance policy insured against any tax loss arising from any successful challenge by the IRS that the construction of the project began after 2016. The certainty gained by purchasing the tax insurance added value on all sides.

CAC Specialty™

Expanding what's possible for solving risk challenges – from the **simple** to the **previously unsolvable**