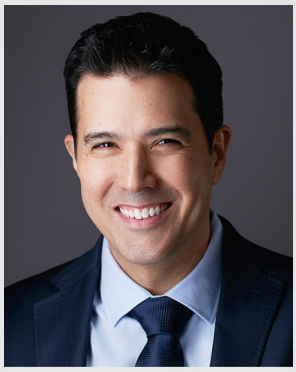
A Tax Practitioner's Guide to Tax Insurance

by Matthew Movafaghi and Jordan Tamchin



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In this article, Movafaghi and Tamchin explain why tax insurance is the preferred solution to mitigate contingent risk for some tax positions.

I. Summary

Tax insurance[1] is an effective and economical risk management tool to provide certainty to tax positions. It is no longer solely used to facilitate mergers and acquisitions or tax equity transactions. In fact, companies are more frequently using tax insurance outside the M&A context in the ordinary course of business to enable internal transactions or tax positions that may have otherwise been tabled.

As Benjamin Franklin famously stated, "In this world nothing can be said to be certain, except death and taxes."[2] Unfortunately, the tax treatment of some transactions can be far from certain. Although companies generally gain some comfort through tax opinions and private letter rulings, both have drawbacks. A tax opinion from a law firm or accounting firm generally provides a level of comfort, penalty protection, and assistance with an evaluation of reserves for purposes of Financial Accounting Standards Board Accounting Standards Codification (ASC) Subtopic 740-10.[3] An opinion does not, however, mitigate a taxpayer's liability regarding the tax issue. Although a private letter ruling provides assurance from the IRS on the tax implications of a transaction, one cannot be sought for every issue, and the process to obtain a letter ruling is often lengthy and uncertain. Tax insurance bridges those gaps by providing financial certainty on a tax issue in a matter of days. Generally, if a tax position is supported by at least a more likely than not level of comfort, tax insurance is an available option.

This article addresses the reasons a taxpayer would want to obtain tax insurance. First, it provides insight into a taxpayer's motivation to seek a tax opinion or private letter ruling. Second, it provides a general overview of tax insurance, explains how it can be used as a substitute for a private letter ruling, and addresses some practitioners' concerns regarding tax insurance. Third, this article discusses how one obtains tax insurance, and it provides common examples of its use. This article concludes that, given the shortfalls of tax opinions and private letter rulings, tax insurance should be considered the

[1] Tax insurance goes by various names, including tax liability insurance, tax opinion insurance, tax risk insurance, tax risk transactional insurance, and tax indemnity insurance.

[2] Letter from Franklin to Jean-Baptiste Le Roy (Nov. 13, 1789).

[3] Formerly known as FIN 48.

preferred solution to mitigate contingent risk for some tax positions.

II. Tax Opinions and Letter Rulings

Tax opinions and private letter rulings are tried and true procedures to analyze and mitigate the tax consequences of transactions. However, both have drawbacks as tools for managing potential tax liabilities.

A. Tax Opinions

A tax opinion is a formal written statement that contains the judgment of the legal practitioner and firm drafting the opinion on a particular tax issue.[4] Typically, most issues that require an opinion are not clear-cut, and the ambiguity in the tax law is what drives a taxpayer to seek an opinion.[5] A taxpayer obtains tax opinions for various reasons: protecting against penalties, determining a level of comfort, satisfying a closing condition in an M&A transaction, or evaluating reserves for ASC 740-10 purposes.[6] An opinion thoroughly documents facts, circumstances, law, authorities, and legal theories to arrive at a conclusion on the merits of a tax position. Generally, practitioners do not take into account audit risk or settlement likelihood when drafting an opinion; rather, they issue opinions on the merits assuming a taxing authority has all the facts available to it.

A tax opinion concludes with a level of comfort on the tax position (for example, should, will, or more likely than not).[7] Some terms, such as "more likely than not," "reasonable basis," and "substantial authority" are based in the tax code or regulations, whereas other terms, such as "should" or "will," are not.[8] This can result in multiple tax advisers being at different levels of comfort on the same issue — one may be at a should level while another is at a more likely than not level.[9]

Although there is no official rule or regulation to determine what percentage chance of success corresponds to a particular opinion level, the following table reflects what we find to be common practice among tax professionals[10]:

Tax Opinion Standards

Standard	Percentage Chance of Success
Will	90% +
Strong should	80% +
Should	70% +
Weak should	60% +
More likely than not	>50%
Substantial authority	40% +
Reasonable basis	20% +

While often cited as a reason a taxpayer obtains an opinion, penalty protection is rarely the sole purpose.[11] Ultimately, the taxpayer wants to succeed on the merits of its tax position if challenged by a taxing authority, regardless of whether the opinion provides penalty protection.[12] Further, an M&A transaction may require a tax opinion as a condition to closing the underlying transaction — for example, an opinion that the transaction will qualify as a tax-free reorganization.[13] And companies that are subject to generally accepted accounting principles may seek an opinion to evaluate whether a tax reserve may be required for ASC 740-10 purposes.[14]

Generally, a taxpayer's primary purpose for obtaining an opinion is for advice on an issue, not an indemnity.[15] Although a tax opinion is a good

[4] Heather M. Field, "Tax Lawyers as Tax Insurance," 60 *Wm. & Mary L. Rev.* 2111, 2122 (2019).

[5] Robert Rothman, "Tax Opinion Practice," 64 *Tax Law.* 301, 311 (2011).

[6] *See id.* at 301-311.

[7] *Id.* at 311-327.

[8] *See id.* at 311.

[9] Reasonable minds can obviously differ on conclusions even when presented with the same facts and law.

[10] For a more through discussion, see Rothman, *supra* note 5, at 311-327. For a fun walkthrough, see Anonymous, "A Detailed Guide to Tax Opinion Standards," *Tax Notes*, Mar. 25, 2005, p. 1469.

[11] Robert W. Wood, "Tax Opinion or Private Letter Ruling? A 12-Point Comparison," *Tax Notes*, Nov. 9, 2015, p. 835.

[12] *Id.* at 835-836.

[13] *See* Rothman, *supra* note 5, at 303.

[14] Generally, public companies must fully reserve for a tax issue if, based on the technical merits, they are not at a more likely than not level of comfort that the position will be sustained upon examination. ASC 740-10-25-6, at 7, 13. If the taxpayer is at a more likely than not level, it will enter a measurement stage to determine the correct amount to reserve for, if any. ASC 740-10-55.

[15] *See* Field, *supra* note 4, at 2153.

method to assess risk, it does not remove the actual risk and shield the taxpayer from potential tax liability. Forum shopping from one practitioner to another in search of a stronger level of comfort does not help, either, because when an opinion turns out to be incorrect, the taxpayer still has a contingent tax liability if the position is successfully challenged by the taxing authority.

One author has argued that tax attorneys provide a sort of quasi-insurance to taxpayers when rendering an opinion by exposing themselves to potential malpractice liability. However, a taxpayer's ability to recover from attorneys depends on malpractice rules — that is, a client would have to prove a tort claim against an attorney, who could, in defense, point to the uncertainty inherent in, for example, a should-level opinion.[16]

B. Private Letter Rulings

If a taxpayer wants the IRS to bless its tax position, the taxpayer may seek a private letter ruling on its specific facts and legal issue. A letter ruling, generally issued by an IRS associate chief counsel, is a written ruling by the IRS that interprets and applies the tax law to a particular set of facts based on a taxpayer's submission and representations. A private letter ruling provides the IRS's view of the tax implications of an identified transaction.

However, a private letter ruling is not without its own flaws. First, it is not always pragmatic because of the time needed to obtain a ruling. In 2013 the Treasury Inspector General for Tax Administration issued a report criticizing the IRS for not providing timely advice.[17] Seventy-seven percent of the samples were late (over 120 days from submission), and the average time to obtain a ruling was 276 days. Waiting nine months or more to obtain a private letter ruling is impractical in most contexts — especially in an M&A transaction, in which the timeline is often compressed.

Second, the IRS will not rule on all tax issues. In fact, the IRS provides a comprehensive list of no-rule areas.[18] For example, the IRS will not rule on some issues related to section 355 spinoffs,[19] whether a transaction has a business purpose or a principal purpose to reduce federal taxes,[20] whether the economic substance doctrine is relevant to any transaction,[21] or any matter in which the determination request is primarily one of fact (for example, the market value of property).[22]

Third, the process to obtain a private letter ruling is rigid and does not allow for much flexibility if the underlying facts change. Thus, any deviation from the facts and representations provided to the IRS in connection with the ruling may render its conclusion inapplicable to the actual transaction.

In summary, both tax opinions and private letter rulings have drawbacks when relied on for tax planning. On one hand, while an opinion can provide a level of comfort on an issue, the contingent tax liability remains with the taxpayer. On the other hand, while a private letter ruling may provide financial certainty on a tax position, it is rigid, available for only limited issues, and can take several months or longer to obtain, which may not be practical from a business perspective.

III. Tax Insurance

A. General Overview

Tax insurance is an often misunderstood and underused tool to manage potential tax liabilities. It protects taxpayers against tax losses arising from a taxing authority's challenge to an insured tax position. It covers additional taxes, interest, and penalties on those taxes; the costs to defend the taxing authority's challenge; and a gross-up, which are taxes incurred upon the receipt of the insurance proceeds, up to the limits purchased by the taxpayer. Tax insurance is used by taxpayers as an alternative to the limitations and

[16] *Id.* at 2133 and 2141.

[17] TIGTA, "Chief Counsel Can Take Actions to Improve the Timeliness of Private Letter Rulings and Potentially Reduce the Number Issued," 2010-10-106 (Sept. 10, 2010).

[18] Rev. Proc. 2021-3, 2021-1 IRB 140; and Rev. Proc. 2021-7, 2021-1 IRB 290.

[19] Rev. Proc. 2021-3, at section 3.10(62).

[20] *Id.* at section 3.02(2).

[21] *Id.* at section 3.02(1).

[22] *Id.* at section 4.02(1).

uncertainties that accompany private letter rulings and tax opinions.[23]

B. History and Use in M&As

Tax insurance has been around since the early 1980s. It was created to fill a market need to facilitate transactions that would not otherwise close because of an identified tax issue.[24] In the last decade, it has frequently been used to complement the representation and warranty insurance (RWI) increasingly found in M&A transactions. RWI provides insurance for financial losses from breaches of representations and warranties (including tax representations) in the underlying acquisition agreement that are unknown to the buyer at the time coverage is bound.

Typically, any known issues identified during diligence, such as a tax issue, are excluded from RWI coverage. This exclusion leaves the buyer uncovered for the identified tax risk, and the buyer is generally left with the choice to self-insure the tax risk, request a purchase price reduction to account for the risk, or seek a separate tax indemnity and possible escrow for the identified risk. Tax insurance is a perfect tool to bridge the gap between the buyer and the seller and enable the parties to receive the full intended economic benefit of the transaction, as described by the Hartford in comments to the IRS:

> Tax insurance provides a needed alternative to the expenses, limitations, and uncertainties associated with private letter ruling requests. Purchasers of tax insurance tend to be conservative, highly risk-averse taxpayers (or their lenders or investors) who choose to reduce or transfer even a modicum of tax risk identified in their transactions in order to increase certainty. Tax insurance was created due to a market need for a financial product to facilitate extraordinary transactions that may not otherwise close within the desired time frame because of the uncertainty with respect to a tax issue. For example, an auction bid typically cannot be contingent upon or delayed until the receipt of a satisfactory private letter ruling or pre-filing agreement.[25]

In the M&A context, there is generally insufficient time to obtain a private letter ruling on a tax position, even if it is possible to obtain one, and a tax opinion, while helpful, still leaves the taxpayer with a contingent tax liability. However, with tax insurance, a potential deal-breaker tax issue can be transferred from the deal parties to the insurance markets.

C. Recent Expansion and Use

Over the last decade, the tax insurance market has significantly matured and, as a result, the total insurance capacity for any one tax issue has drastically increased. While five to seven years ago there were only a handful of U.S. insurance markets willing to underwrite tax insurance, there are now more than 15 U.S. insurance markets with at least $50 million of capacity, enabling a tax insurance program exceeding $1.5 billion for a single U.S. tax risk.

There has also been significant growth in the use of tax insurance to protect against tax risks outside the M&A context. 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 — because there is no clear guidance on the tax issue, the fact pattern is unique, or the tax position requires a degree of judgment (for example, valuations) or an evaluation of intent (for example, business purpose).

Some companies are using tax insurance on multiple transactions per year and recognize the utility in using insurance to get transactions closed while reducing risk, obtaining board approval for internal transactions, and enhancing shareholder value. If there is a more likely than not position that would otherwise not be taken on a return because of an outsized liability, tax insurance should be considered because the cost of insurance will be significantly less than the

[23] The Hartford comment letter (Dec. 2, 2002) (submitted by David S. De Berry).

[24] *See* Field, *supra* note 4, at 2129 n.94.

[25] *See* Hartford comment letter, *supra* note 23.

potential savings, thus increasing shareholder value.

As an example, assume a taxpayer has a tax opinion at a more likely than not level of comfort on a tax issue, and the tax savings from executing the transaction is $100 million. If the taxing authority disagrees with the intended tax treatment, however, the total liability may be $300 million (including additional taxes, penalties, and interest). The taxpayer may not want to take on the risk of that outsized liability or to reserve for it under ASC 740-10,[26] and it may not have time to wait for a private letter ruling. To allay this risk, tax insurance can be purchased before or after the tax position is reported on a return, which can provide liquidity while avoiding the negative cash impact arising from a potential tax liability.

The maturation of the tax insurance market provides numerous unexplored opportunities that tax directors, risk managers, and CFOs should consider.

First, the increased competition in the tax insurance market has made tax insurance more economical and relevant for insureds. The cost of the insurance has significantly dropped. Most U.S. tax risks can be insured for 2 to 4 percent of the limits purchased. This is less than half the amount it would have cost a decade ago. What tax director, while under audit for an issue, would not happily settle a contested issue for 2 to 4 cents on the dollar?

Second, the scope of potentially insurable tax risks has vastly expanded. Tax insurance can now be used to insure income and non-income taxes as well as U.S. and non-U.S. taxes. As a result of the increased sophistication of tax underwriters and tax brokers, more complex tax risks are being insured that were previously uninsurable. While the scope of insurable tax risks is extensive, it is not unlimited.[27] The tax insurance market does not insure aggressive transactions, tax shelters, and listed transactions. As the Hartford observed in its comments to the IRS, "By refusing to insure tax shelters, abusive schemes, and weakly supported tax positions, the tax insurance industry injects a distinctly conservative evaluation within the community of tax professionals and helps to cultivate a culture of compliance in which corporate tax shelters are less often created."[28]

Third, the industry has become conditioned to provide deal-time solutions. If there is a tax opinion or robust memo available, a policy can be bound in a matter of days.[29] "Tax insurance allows customary commercial transactions (albeit complex transactions) to proceed timely and with certainty of the tax consequences," the Hartford explained.[30]

This growth has expanded the possible applications of tax insurance in the ordinary course of a taxpayer's business because of the cost reduction in the product, the wider range of issues that can be covered, and the broader appetite to cover even risks carrying a more likely than not level of comfort.

D. Combating Misunderstandings

Frequent misunderstandings and criticisms have prevented taxpayers and tax advisers from considering the use of tax insurance. The following are common critiques of tax insurance.

1. Tax insurance is an unnecessary, incremental deal cost.

Although tax insurance is an additional cost — typically 2 to 4 cents on the dollar of limits purchased — it provides certainty and precludes tax issues from being deal-breakers.

2. Tax insurance is an additional agreement that needs to be negotiated and will slow down the deal.

Given the sophistication of the tax insurance market, tax underwriters work on "deal time" to provide insurance solutions. Moreover, leading brokers and law firms have negotiated strong policy language on behalf of policyholders that

[26] Tax insurance can in some circumstances provide the ancillary benefit of managing the company's tax reserve under ASC 740-10. *See* Lee A. Sheppard, "Do Corporations Need Tax Risk Insurance?" *Tax Notes Federal*, Dec. 7, 2020, p. 1547.

[27] Common insurance risks include real estate investment trust status, subchapter S corporation status, debt-equity treatment, deduction versus capitalization of expenses, accounting method, research and development credits, carryback of net operating losses, and transfer pricing.

[28] Hartford comment letter, *supra* note 23.

[29] This depends on the complexity of the issue, and the level of comfort from the tax advisers, but most policies can be bound within two weeks of a submission to the insurance market — some much faster.

[30] *See* Hartford comment letter, *supra* note 23.

can be used as a starting point for negotiating the specific policy for a particular placement — which further facilitates an efficient placement process.

3. Tax insurance claims are not actually paid.

Tax insurance claims have been paid. Also, there are numerous pending claims for insured positions that are working their way through audits and the courts. On RWI policies, the second-largest payout is for tax issues — yes, these claims are for *unknown* tax issues (as of the time of binding coverage), but the point remains that the transactional insurance markets are covering losses arising from tax liabilities.[31]

Any failure of the insurance market to respond to a loss under the policy would be the demise of the tax insurance product. Bill Kellogg, global head of tax insurance at Berkshire Hathaway Specialty Insurance, says that "Berkshire paid a full limit loss within one week of the tax authority making their final settlement offer . . . and because tax insurance is a long tail business . . . we expect many more claims will be paid in the future."

4. A tax insurance claim would involve fighting with the insurer for coverage.

A tax insurance policy is a heavily negotiated contract between the insured and the insurer that specifically defines the insured tax position and the items of loss to be covered under the policy. If there is a final adjudication of a claim, the policy is clear about the amount owed by the insurer to the insured under the policy. Thus, rarely, if ever, has there been a coverage dispute concerning a claim under a tax insurance policy. Moreover, all the participating insurers are well-respected participants in the insurance market and rated at least A by A.M. Best Co. Inc.

Tax insurance is a specialized insurance product for a known tax issue. Kevin Tighe, director of tax at Ambridge Partners LLC, says that "in the event of a claim, there shouldn't be a disagreement over what may or may not be covered."

In discussing tax insurance claims, some practitioners appear to mistake a tax claim made under a RWI policy with that of tax insurance. Unlike an RWI policy, in which the quantum of damages is unspecified for a tax issue (unknown at the time of the policy) and must be negotiated with the insurer post-claim, a tax insurance policy specifically identifies the items of loss to be covered, and the amount of loss paid to the insured is determined by a final adjudication.

The process to obtain tax insurance is collaborative because the insured, the insurer, and their advisers must be sufficiently comfortable with the risk to be able to transfer it to the insurer's balance sheet. Similarly, during the claims process when contesting a challenge to a tax authority, the insured and the insurer must work together in good faith. As explained by Joey Juhn, senior vice president of tax at Ethos Specialty Insurance Services LLC, "the fact that tax insurance policies involve third party claims rather than direct claims make them less adversarial by nature." Tighe also says that "tax insurance is underwritten for one or more specific, identified tax positions, with policy terms and conditions negotiated. . . . As a result, the process and the coverage should be clear."

5. Insurers will meddle in an IRS audit.

Insurers do not "meddle" in an IRS audit. Under a typical policy, the insured has a duty to defend the claim (although the cost is borne by the insurer, subject to any retention), and the insurer has reasonable participation rights (although the insured cannot settle a claim without the insurer's consent, which is not to be unreasonably withheld). Because the insurer's money is at risk if there is a loss, and the insurer has consent rights, tax insurance cannot be used as settlement currency or to horse-trade with another uninsured issue during audit. Generally, insureds welcome the additional advice offered by insurers, who are typically represented by their own legal counsel. Kellogg elaborates that "when an insured tax position is challenged by a tax authority, the role of the insurer is generally a passive one. In a tax dispute regarding a position we recently insured, we are 'shadowing' the taxpayer and their counsel, who are leading the defense."

[31] Mary Duffy et al., "M&A: A Rising Tide of Large Claims," American International Group Inc. (2020).

6. Tax insurance encourages tax abuse by allowing taxpayers to take risky positions.

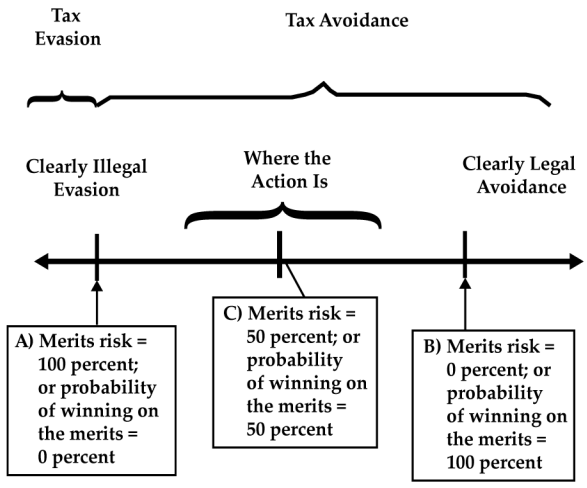
This argument was discussed in an article by Kyle D. Logue early in the history of tax insurance.[32] The article describes a continuum of tax positions of relative strength (see the figure). Tax evasion, which appears the furthest left in the image, occurs when a taxpayer does not report an item of income or has no argument that the tax position is consistent with the law.[33] Tax avoidance — arranging one's affairs to minimize tax liability lawfully — covers the remainder of the spectrum.[34] Tax insurance would encourage abuse only if it assisted with tax evasion, not tax avoidance.

In the course of obtaining tax insurance, the insured's tax position is reviewed and vetted at multiple levels. First, the insured has hired tax counsel to evaluate an issue and provide an opinion. Second, a dedicated and experienced tax insurance broker, who is typically a tax professional and preferably a tax attorney, has reviewed the opinion to prepare a submission for the insurance market. Third, the tax underwriter, who is generally a former tax attorney or tax accountant and typically engages outside counsel to help in the underwriting process, underwrites the risk transfer. In effect, tax insurance provides a second evaluation on the tax position by the underwriter's tax professionals.[35] As the Hartford explained:

> Tax insurance is underwritten by or with the support of tax attorneys who carefully review a transaction to "weed out" weak tax positions and insure strong tax positions. In stark contrast to certain tax practitioners (and promoters) who generate fees by creative application of the Tax Code, tax insurance underwriters are "rewarded" for providing a conservative, prudent analysis of a proposed tax position.[36]

As noted, the insurance market insures only tax risks that are supported by at least a more likely than not level of comfort on the merits. Consistent with this, the market does not play audit roulette — although the low rates available are partially driven by the possibility a position may not be audited. For the insurance market to succeed, it must insure legitimate tax positions. The insurers are putting up their own capital in case the tax position is not sustained. Ultimately, insurance companies are looking to make money, and insuring non-legitimate tax positions would not be in the best interest of the insurer's business.

Figure From 'Tax Law Uncertainty and the Role of Tax Insurance'



Source: Logue, "Tax Law Uncertainty and the Role of Tax Insurance," 25 *Va. Tax Rev.* 339, 360 (2005).

Logue also argues for tax insurance on the basis that there is a social benefit for taxpayers to be able to take tax positions that are at a more likely than not threshold while understanding the financial ramifications before taking the position:

> Over-compliance, for example, might mean that taxpayers would tend to avoid taking positions that approached the more-likely-than-not threshold — that is, they would stay comfortably to the right of Point C — by avoiding even remotely questionable transactions or reporting positions. All these types of over-compliance constitute social waste and can even produce distributional inequities insofar as the effects of the legal

[32] Logue, "Tax Law Uncertainty and the Role of Tax Insurance," 25 *Va. Tax Rev.* 339 (2005).

[33] *Id.* at 353.

[34] *Id.* at 354.

[35] *See* Hartford comment letter, *supra* note 23.

[36] *Id.*

> uncertainty and differential risk-bearing are unfairly distributed across taxpayers.[37]

In another article, Richard A. Wolfe responds to the question of whether tax insurance helps facilitate tax shelters or encourages aggressive tax planning:

> The answer, I believe, is absolutely not. In fact, Insurers that issue TIIPs [tax indemnity insurance policies] actually strengthen the integrity of our tax system. Before issuing a TIIP, an Insurer will do thorough diligence regarding the tax risk under consideration. The Insurer will not issue the TIIP if its diligence reveals that the tax planning is aggressive. That is why the premiums charged for TIIPs traditionally have been relatively modest as compared to the policy limits. Indeed, TIIPs may actually deter tax shelters and aggressive tax planning. For example, if a company is contemplating pursuing a particular tax plan, and the CFO of the company tries to obtain a TIIP but cannot do so because the plan is too aggressive, the company may be deterred from pursuing the plan. At bottom, the TIIP underwriting process provides an informed assessment of complex tax risks by a sophisticated, neutral third party — a party with a strong economic incentive to confirm that the tax risk being insured conforms to the tax laws. This is good for our tax system.[38]

Far from criticizing tax insurance as abusive, the IRS has provided tacit support of tax insurance. In Rev. Proc. 2014-12, 2014-3 IRB 415, and Rev. Proc. 2020-12, 2020-11 IRB 511, the IRS identifies tax insurance as the preferred means to protect the tax equity investor against specified tax risks.

[37]Logue, *supra* note 32, at 373.

[38]Wolfe, "Tax Indemnity Insurance: A Valuable and Evolving Tool for Managing Tax Risks," at 445, para. 1-72, in *The Corporate Tax Practice Series* (2011).

IV. Obtaining Tax Insurance

So how does one obtain tax insurance? A taxpayer needs to work with an insurance broker to procure tax insurance on its behalf. It is prudent for the taxpayer to work with an experienced broker who has all relevant insurer relationships and appointments as well as technical tax expertise in the law. Part of the broker's job is to get the insurance market comfortable with the risk transfer to entice competition among insurers. Thus, being able to fully understand the technical merits of the risk transfer is paramount.

A taxpayer should contact its tax insurance broker as early as possible to discuss the risk transfer, the insurability of the tax risk, the pricing of the insurance, and next steps. The taxpayer then provides the broker with all relevant documents to review and prepare a submission for the insurance market to obtain competitive pricing and terms.

The submission then is sent to the insurance market, which generally responds within 72 hours with proposals setting forth terms. There is no upfront cost to a taxpayer to seek proposals from the insurance market. If the taxpayer wants to move forward with a tax insurance policy, the taxpayer then selects an insurer by executing the proposal and paying a nonrefundable underwriting fee, which is typically $30,000 to $50,000 — depending on the coverage being sought. At that point, an insurer is formally engaged and begins to finalize its underwriting, which generally consists of reviewing any final documentation and having an underwriting call with the taxpayer's advisers. During this period, the taxpayer and its counsel also are negotiating the terms of the tax insurance policy. The process to finalize underwriting and negotiate the policy typically takes seven to 10 business days. However, if needed, the insurance market can respond sooner and provide deal-time solutions. After underwriting is finalized and the policy has been fully negotiated, the insurer is ready to bind coverage.

Here are some examples of how tax insurance has been used to solve issues in M&A transactions as well as in the ordinary course of business.

Example 1: A buyer sought to acquire a target entity that elected to be treated as an S corporation for federal income tax purposes. During tax due

diligence, the buyer's tax adviser discovered that one of the trusts was not a permissible S corporation shareholder of the target. If the target's S corporation status was terminated, the target would be treated as a C corporation and be subject to corporate-level tax for all open tax years. Moreover, the buyer would be unable to make a section 338(h)(10) election to step up the tax basis of the 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. The sellers secured a tax insurance policy for the benefit of the 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. That amount 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 and thus allowed the parties to close the transaction swiftly and confidently.

Example 2: A buyer agreed to pay additional purchase price consideration because the corporate target had material net operating losses that could benefit the buyer post-closing. Sellers provided documentation to support the quantity of the target's NOLs. And the sellers provided documentation to support that the target had not previously experienced an ownership change, which would otherwise significantly limit the buyer's ability to use the NOLs. Despite that documentation, the buyer wanted certainty regarding the amount and availability of target's NOLs to be used in the post-closing period. The 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 the target's NOLs and the availability of those NOLs to be used in the post-closing period. The buyer not only insured the ability to use the NOLs (thereby locking in the commercial value of the NOLs) but also was insured against any tax losses that would arise from a successful challenge by the taxing authority.

Example 3: A private equity fund was interested in acquiring the shares of a global manufacturing company, but for business purposes, it did not want to acquire specific assets held by the target. Before closing the transaction, the target distributed the unwanted assets to its shareholders, which resulted in taxable gain to the target. Although 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 if the IRS challenged either the FMV or tax basis of the unwanted assets. 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 the appreciated assets to the shareholders would be respected by the taxing authorities.

Example 4: 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 they were conducted at arm's length. The transactions included interest from intercompany financing, profit margins, and royalties for the use of intangibles. The company purchased a tax insurance policy with limits of $55 million for any tax loss resulting from any successful challenge by the IRS.

Example 5: A private equity fund was seeking to acquire a portfolio of real estate assets that were held in a real estate investment trust. The seller was unwilling to provide an indemnification for any breach of the representations and warranties under the purchase agreement. The potential tax exposure, which concerned the target's REIT qualification, exceeded 30 percent of the enterprise value. The buyer secured a hybrid REIT RWI 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. That policy, with limits of $60 million, allowed the transaction to close.

V. Conclusion

Tax insurance removes the tax uncertainty from M&A transactions, any contemplated tax planning (for example, internal reorganizations, restructurings, or transactions with shareholders), as well as any internal transactions or events that are part of a company's ongoing

business operations (for example, transfer pricing, accounting method, research credits, and NOL carrybacks). As such, a taxpayer can use tax insurance to execute the underlying transaction, investment, or event with complete knowledge of the financial consequences of taking a tax position.

The tax insurance industry has significantly matured over the last decade, and tax insurance is now an economical and efficient risk management tool to transfer economic risk of a tax loss to the insurance market. The policy can provide downside protection against tax liabilities in the hundreds of millions of dollars for pennies on the dollar in a matter of days. That is quite a feat. When used properly, tax insurance can allow a taxpayer to achieve complete financial certainty when planning a transaction that might not otherwise have been executed because of a potential outsized tax liability and the shortcomings of obtaining a private letter ruling or tax opinion. ■