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## THE "MOST INTERESTING MAN IN THE WORLD" OF R&D TAX CREDITS

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TEI ROUNDTABLE: TAX INSURANCE

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CHAPTER LEADER: SCOTT TINCHER

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MEMBER PROFILE: DANIELLE BELUCH

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ASK THE EXPERT: MARY MCNULTY

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**TEI**

# TEI Roundtable No. 41: Tax Insurance: An Agent of Change

It's on the front burner these days

**T**he tax insurance market is rapidly evolving and its benefits are becoming more widespread, especially in the area of mergers and acquisitions. To find out more about what's happening in this space, we convened a roundtable comprising four knowledgeable professionals who gave us the real skinny on tax insurance: Jordan Tamchin, tax insurance practice leader, and Matt Movafaghi, senior vice president of tax insurance, both at CAC Specialty; Scott Harty, partner, federal and international tax, at Alston & Bird LLP; and Michael Saitta, head of tax insurance at Liberty GTS, a business unit within Liberty Mutual. *Tax Executive's* senior editor, Michael Levin-Epstein, moderated the discussion in November 2022.



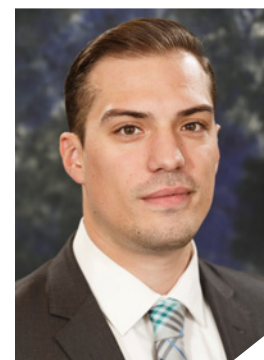
Jordan Tamchin



Matt Movafaghi



Scott Harty



Michael Saitta

**Michael Levin-Epstein:** I'd like to begin with an overarching question and have Jordan address it. What is tax insurance?

**Jordan Tamchin:** Tax insurance is a risk management tool that protects the insured against a tax loss arising from a taxing authority's challenge to a tax position. It covers items such as additional taxes, interest and penalties on those taxes, contest costs, which relates to the cost to defend the taxing authority's challenge, as well as gross-up, which are the taxes incurred upon the receipt of the insurance proceeds. This allows the insured to execute the underlying transaction or investment, or take a certain tax position with complete tax certainty, and provides them a level of comfort similar to a private letter ruling. Effectively, it's a risk management tool allowing the insurer to transfer the economic risk of a tax loss in the insurance market.

### Tax Insurance Market

**Levin-Epstein:** The next question is directed toward Scott and Michael. I think that our members would appreciate hearing an update on the tax insurance market in the last year or two. Scott, let's begin with you and then turn to Michael.

**Scott Harty:** I think that the market over the past year or two has been evolving quite rapidly and trending toward certain types of risks. Lately, we've seen more sophisticated tax planning risks with relatively large towers. Where traditionally you see policy limits of between \$25 and \$100 million, we're starting to see risks more commonly exceed \$100 million. Also, the level of complexity of the risks that we are seeing is increasing. I think that's a good trend to see in terms of market penetration. We're also seeing a variety of risks hit the market, and so areas that would not be traditionally common, in my estimation, we're starting to see more of, such as trust and estate issues, state tax issues, [and] inversions as well as incredibly unique uses of the product. Beyond an S corp or a renewable energy credit risk or REIT [real estate investment trust] risk, we're going beyond that into new areas, which is exciting. One other thing to note is that there has been some more appetite for valuation-related risk, which traditionally has not been a common area for insurance. There's been a lot of hesitation around valuation, but I think now we're seeing some willingness to consider it. I wouldn't say it's strong, but it's at least increased. So overall there's been a nice evolution of the product, and folks like Jordan and others have done a good job in helping to get the word out, and it's growing quickly.

**Michael Saitta:** I would agree with pretty much everything that Scott said. I think the increase in the

number of different types of risks, and the expansion of what can be covered, is the headline story. As we are able to assess and consider new risks, we continue to see other opportunities. While the product, historically, was largely focused on issues that came out of M&A-type transactions or deals, we are now seeing a lot more potential opportunities for tax positions to be covered that arise from typical everyday business operations. Obviously, potential tax impacts and costs are a material consideration in the daily operations of a given business, so the ability to use tax insurance to address more of what comes up in the normal course has been important. Scott's point about our ability to address larger risks in terms of the total dollar amount has also been really beneficial to the overall tax insurance market. Certainly we see a trend toward more risks with potential cross-border implications, and the number of jurisdictions that these risks touch has expanded, which I think has been very helpful. For example, just within the Americas, we have recently seen a big uptick in tax risks which involve Canada and Latin America, as opposed to historically being mostly US-focused. The market can certainly address many other international regions or jurisdictions as well. Another very interesting area that, similar to Scott's point on valuation, is in the early stages and is going to hopefully continue to develop, are instances where, with the right fact patterns, we can potentially insure what we would refer to as "live risks." That is, situations where a risk has been identified by a particular taxing authority which may be an early- or middle-stage challenge to an ongoing audit or examination. In order to be a good fit for insurance coverage, those scenarios do require a set of particular facts and circumstances, but it's definitely an area that we expect to continue to grow.

**Levin-Epstein:** Matt, can you weigh in here?

**Matt Movafaghi:** I think I would just add that over the last five years, tax insurance has really matured. Tax practitioners might not have had tax insurance at the tip of their tongues, if they even knew it existed. But just to give you a sense of how much the industry has matured, back in 2016 there were only three markets participating and \$250 million of total capacity in the market for tax insurance for any specific US issue. Now, there are twenty markets that will write insurance on a primary risk, with about ten markets that have \$50 million in capacity. So, that really allows competition in terms of pricing and just adds a lot more optionality for our clients. There's been a lot of tax practitioners that have come into the market as well. You have brokers, like myself and Jordan, that are tax attorneys, and you have tax attorneys like Mike on the underwriting side, and then they use outside

counsel, like Scott. So, there are a lot more people with tax experience involved in the process. And as a result of the increase in the insurers, policy prices generally have come down. Five to six years ago, you might be paying five to seven cents on the dollar. Now it costs two to four cents on the dollar of the amount of limits purchased. As Mike alluded to, now there are a lot more types of risk that can be insured, since there are so many more tax practitioners in the space. It's not just US federal risks with a "should" level of comfort that can be insured; one can now insure "more likely than not" risk on a US federal issue or state issue. We can insure income and non-income taxes. We can insure foreign tax risks, withholding taxes, VAT, etc. So, I think it's really matured a lot over the last five years, and it's worth noting.

"Where traditionally you see policy limits of between \$25 and \$100 million, we're starting to see risks more commonly exceed \$100 million."

—Scott Harty

### M&A Transactions

**Levin-Epstein:** I'd like to turn to Jordan for more explanation about how tax insurance is used in M&A transactions.

**Tamchin:** In the M&A context, tax insurance complements what's known as representation and warranty insurance, which is a common risk management tool. I think about seventy percent of all middle-market transactions use rep and warranty insurance now. Rep and warranty insurance covers the unknown breaches of all the representations and warranties, including tax representations, made by the seller in the purchase agreement. Typically, any known issues identified during diligence and included on the disclosure schedules—for example, a known tax issue—are typically excluded from coverage under the rep and warranty policy. This exclusion leaves the buyer uncovered for that identified tax issue, and the buyer is generally left with the choice to either self-insure the tax risk, request a purchase price reduction to account for that tax risk, or perhaps seek a separate tax indemnity and possible escrow for that identified tax risk. As none of those options are particularly appealing to either the buyer or the seller, tax insurance is a great way to bridge the gap between the parties.

For those who are thinking about how tax insurance could play a role in M&A transactions, there are three buckets of insurable risk in an M&A

transaction. First, there are tax issues related to historic tax positions taken by the target on [the] seller's watch. For example, a debt versus equity treatment issue, or deduction versus capitalization of expenses, or employee versus independent contractor treatment. Those are all historic-type issues on [the] seller's watch. Second, tax insurance could address tax issues arising from the transaction itself. For example, any type of pre-closing restructuring—for example, the target distributes out an unwanted asset and it could have 311(b) gain, this goes to a valuation and tax basis issue. There could be questions about the tax treatment of a transaction as either tax-free or taxable, or the availability of a tax basis step-up. The third bucket of risk is tax issues arising from the entity classification of the target, which was a very common risk transfer when tax insurance was first coming to market. For example, subchapter S qualification status, or real estate investment trust qualification, or master limited partnership status. Those are the broad areas of risk that one should consider in an M&A transaction.

When considering the benefits of tax insurance in M&A transactions, first and foremost, it really helps close the deal. It takes an otherwise potential deal-breaker tax issue off the table by facilitating deal negotiations and eliminating the need for a tax indemnity or escrow. Some of my favorite success stories all have involved tax insurance saving that deal, because the potential exposure may be just as large as the enterprise value of the transaction. Second, tax insurance enables a clean exit by eliminating that long-tailed contingent tax exposure. It allows the seller to retain all the sale proceeds without having to put any proceeds into an escrow. Lastly, tax insurance offers liquidity while avoiding the negative cash flow rising from the tax liability itself. This is really the most important part about tax insurance. It protects the balance sheet of the taxpayer by making them whole in the event the taxing authority challenges that known tax position.

**Levin-Epstein:** I think our members will be intrigued to hear an example of where tax insurance saved the day in an M&A transaction.

**Tamchin:** I'm happy to provide an example that we're currently working on. We have a rather small transaction, enterprise value is around \$40 million, and we're dealing with a potential transfer pricing issue related to expenses that are being pushed down from a fund down to its subsidiaries. The question around transfer pricing could potentially hold up the deal because the underlying risk is whether those expenses should be pushed down to the target entity. If those expenses are disallowed,

we're talking about an exposure of \$20 million-plus, which is about half the size of the enterprise value. And so, if the taxing authority were to disallow those expenses, it would blow up the entire transaction for the buyer.

**Movafaghi:** I also have another example of tax insurance that saved the day in an M&A transaction. We were working on a project with two companies, a buyer and a seller. The seller leased goods into Mexico, and the buyer thought that the company may or may not have a permanent establishment in Mexico, and they couldn't quite get comfortable with the risk. The deal size was \$80 million, but the tax exposure could have been up to \$20 million. So, this was an instance where the deal actually did die briefly, but then they reached out to us to obtain tax insurance on the issue, and we were able to get a policy together and be ready to bind within a week of the client reaching out. And we have had lots of kudos on both sides of the transaction for being able to place a Mexico PE risk quickly. People didn't think it was really a big risk, but the value of that risk was so outsized compared to the deal that nobody wanted to take on the risk themselves. The buyer didn't want to take on the risk, the seller didn't want to have indemnity or escrow or lower their purchase price proceeds. And so, tax insurance came in and saved the day in that M&A transaction.

“But just to give you a sense of how much the industry has matured, back in 2016 there were only three markets participating and \$250 million of total capacity in the market for tax insurance for any specific US issue. Now, there are twenty markets that will write insurance on a primary risk, with about ten markets that have \$50 million in capacity.”

—**Matt Movafaghi**

**Harty:** Can I give one more example? I don't see this a lot, but I have seen transactions where you have a delayed closing after signing and the purchase agreement contains a covenant that says “you will get tax insurance for this issue,” whether it's a pre-closing restructuring or some type of issue embedded in the target. And, essentially, if you don't get tax insurance under these conditions,

then the deal doesn't close. So, in that sense, tax insurance is absolutely necessary for the transaction to close, and it is built into the purchase agreement as a closing condition.

**Saitta:** I think Jordan also raised a category of risks earlier that is not a specific anecdote but can be very beneficial to an insured. When you have an acquisition of a portion of a business, or are acquiring something in a carve-out-type transaction from a larger structure, there are often several different ways that separation can be achieved, with (potentially very) different tax consequences in each of the alternatives. While those alternatives may have a similar risk profile, they may have very different commercial or nontax business outcomes that could benefit or favor either buyer or seller. So, if the parties agree that there is a real business benefit to one side, but they are less comfortable with the tax outcome, it is usually the case that we can address the tax uncertainty with an insurance policy so the parties can move forward with that alternative restructuring or plan of steps that would give them the best possible commercial outcome.

### Key Policy Terms

**Levin-Epstein:** Scott, could you give us some examples and a general sense of what the key policy terms are in tax insurance?

**Harty:** I think there's definitely a handful of critical terms that one should focus on. The first one, in my view, is the covered tax position, which is really, for the insured, making sure you're getting the coverage you're bargaining for. The covered tax position—some people call it the insured tax position—is essentially the purpose for buying the policy in the first place, but the precise wording of that language in the policy is critical. At the beginning of the process when someone is seeking a policy—and brokers like Jordan and Matt help out the insureds in crafting this language—I've seen the language evolve or maybe be imprecise. It's really critical to get this right and make sure the language is precise, because it is what everyone will look to if there's a claim. It's important for the insurer to understand what they are insuring and for the insured to make sure they feel protected. So, in terms of the policy itself, I think that's one of the key points to focus on.

The other thing is exclusions. There are standard exclusions that every policy contains, such as the accuracy of representations being made, change in law, and that no inconsistent tax positions be taken. But sometimes deal-specific exclusions may be proposed, and those will be a very key element of a policy.

In addition to that, the representations that an insured may need to make will be important to an insurer. Oftentimes in an M&A context

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—Jordan Tamchin

representations are knowledge-qualified. From an insured’s perspective, I think that’s very important to have those representations qualified by knowledge to the extent a buyer may have more limited information than the target does. From an insurer’s perspective, those representations may be beefed up to have sufficient teeth to give the insurer comfort that the key elements underlying the coverage are in fact true.

Retentions are effectively amounts that the insured would have to pay before the insurer has to pay under the policy. I’d be curious to get Jordan’s and Matt’s comments on this, or even Mike’s, regarding retentions. In my view, they’re a little bit all over the place, but I think lately I’ve seen zero-retention policies and the insurer is picking up essentially the first dollar, or very low retentions. I think insureds are looking for the lowest possible retention, but contest costs on audits are, as you may expect, expensive and increasing.

**Tamchin:** No, I think you’re right. Over the last eight years or so, we’ve seen downward movement on retentions, and I think that has to do with the competitive nature of the market. What we generally see now is basically no retention other than for contest costs. Again, that’s the cost of the taxing authority’s challenge. And that generally ranges between \$100,000 to \$250,000. And what we generally see is that contest costs begin to be picked up by the policy as soon as the taxing authority begins to investigate the covered tax position. There has at one time been a movement to say, “I’ll just get rid of my retention altogether and just have contest costs picked up at a later stage, maybe after the administrative appeals level,” but that was short-lived. And insureds generally favor for contest costs to be picked up sooner in the process subject to that low retention for contest costs.

**Movafaghi:** And I would just add, on the retention point, that I think that’s certainly consistent with

what we’ve seen in the market, but it’s important to keep in mind that the nature of the risk typically will also dictate what the most appropriate approach is for the retention, coupled, of course, with the insured’s focus, what’s most important for them, which is also typically driven by sort of the facts and circumstances giving rise to the risk. So, I think it’s an interesting tool that can be used to benefit the insureds, especially as we see it being used in different ways.

**Levin-Epstein:** What are some examples of things that underwriters focus on to distinguish and compare and assess similar potential risks?

**Saitta:** As we mentioned earlier, the trend of seeing an increase in the types of risks that can be covered is a testament to the improvement and growth of the market. So with that growth, first and foremost, it is important that a risk being considered is within the overall appetite of the market and also specifically within appetite for Liberty. That is something that the CAC team have done a great job of taking the initial review and providing strong risks for our consideration. Once a risk submission hits our inbox and is potentially insurable, it is an exercise in looking for certain things that would distinguish the strength of the position to be covered, which would allow us to offer more competitive or appealing terms for the insured. Typically, we’d like to see a clearly defined and thoroughly analyzed technical position for which coverage is being requested. That allows us to analyze the issue. That is similar to Scott’s point about getting the covered tax position language right and having it be concise so that it can focus the underwriting exercise and allow us to work very efficiently. It is a collaborative process, so we look for transparency from the insured and their advisors and an overall open line of communication so that everybody is working together with all of the same information. Making the process collaborative, I think, is a big differentiator. We like to see that the requested limit or the size of the policy that’s being requested is appropriate and adequately sized to the nature of the risk and the total potential exposure (including potential interest and penalties, as well as a cushion for contest costs and in some cases a gross-up to cover the tax cost of receiving a payment on a claim). We would like to see that the insured is comfortable with and understands the covered tax position, and is able to provide their full support, as well as the support of their advisors. The more information and the higher the quality of information that is made available, typically in the form of opinions or reports prepared by the advisors supplemented by supporting documentation and explanation from the insured, the better the process will go. Having

the insured provide any additional facts that would further align the interests of the insured and the insurer will also improve things.

Another critical factor is understanding the motivation for seeking a policy. That is often expressed very well in the submissions that we see. Clarifying that motivation or purpose can really benefit an insured. For example, it was mentioned earlier that having a policy may serve to improve the overall quality of an insured's balance sheet, both in and out of the M&A context. Another simple motivation we often see is any scenario where you have a potentially adverse party or multiple parties who may not be able to agree on the outcome or severity of a particular tax issue. We see that as a strong motivation, as the insurance can clear that impasse. Additionally, any time there is a very focused situation where the clarity or certainty that a policy offers may provide a very large or outsized benefit relative to the likelihood of an adverse resolution, using a tax insurance policy makes sense. Ultimately, when that motivation is one to us which seems worthwhile, that's going to help distinguish it.

"For example, just within the Americas, we have recently seen a big uptick in tax risks which involve Canada and Latin America, as opposed to historically being mostly US-focused."

—Michael Saitta

### Claims

**Levin-Epstein:** One final question for Michael, and others can chime in. Could you describe the claims process?

**Saitta:** Happy to start the ball rolling there. So, we have at Liberty—and I think others in the market do as well—a dedicated claims processing team who have specific transaction insurance experience. We would work very closely with them in a potential claim scenario. The claims team also has the benefit of our tax knowledge and our familiarity with the particular risk, and it's really a very collaborative process between the claims team, myself as the underwriter, and of course the insured and their advisors. Similar to the underwriting stage, the more open, available, and transparent an insured is, the more fruitful the claims process can be for the insured. It is interesting to note that when we think about what a claim is in the context of tax insurance, it results from there being an examination

or an audit by a tax authority, as opposed to a potential third-party dispute, for example. That creates an opportunity for the insurer to partner with the insured to offer their expertise and support to help them in the process, since both parties' interests are aligned in getting the best possible outcome. As Jordan mentioned, the policy allows for covering of certain contest costs in defending the position being challenged on audit. There is also built-in flexibility in the policy to consider potential settlements or other strategies to get to the best outcome. So, again, as long as we have a very collaborative and open process, I think of it as really partnering with the insured to get the best possible results for everyone. So that's one strong point—in a claim scenario, everyone's interests are typically very aligned, which allows it to be an efficient and beneficial process.

**Levin-Epstein:** Anything else to add?

**Tamchin:** I'm actually going to yield my time to Matt, because one thing I think is important for us to hit on is the use of tax insurance in the ordinary course of business, particularly for large corporates that are using it, because that's where we're seeing the biggest growth in the product. I think it's important that we hit on that.

**Movafaghi:** Jordan previously has talked about the proliferation of rep and warranty insurance. Because of that, there have been thousands of rep and warranty policies placed, and there have been many tax issues that have been kicked out of those policies, and that's allowed the tax market to respond and flourish by placing those risks on tight deadlines, and it's set the stage for tax insurance in the ordinary course of a company's business. So, due to that expansion of tax insurance in M&A transactions, tax insurance can now be used to protect companies against contingent tax exposures in their ordinary course of business. The tax code is complex, and despite receiving advice from attorneys or accountants or in-house counsel, the proper tax treatment of a transaction may be uncertain, either because there's no clear guidance on the issue or the fact pattern is unique or because the tax position requires a degree of judgment—Scott mentioned valuations earlier—or potentially an evaluation of intent like a business purpose. And if the IRS disagrees with a company's tax position, the company may owe unanticipated and potentially significant taxes, interest, and penalties. So, tax insurance really removes that financial uncertainty from any contemplated tax planning, as well as internal restructuring, that are part of a company's ongoing business operations.

I think it's worth noting that tax insurance can be purchased either before or after a tax position is reported on a return. Practitioners often ask, "When should I consider using tax insurance in the ordinary course of business?" I would say one instance is if they're ever thinking about obtaining a private letter ruling on the issue. Private letter rulings can often take a lot of time. It's not a foregone conclusion that the IRS will even rule on the issue. They may not rule on your issue to begin with because it's on the no-rule list, or they might not want to rule on your issue specifically. And also due to the length of time, facts might change between when you submit a ruling and at the end when ruling is about to be provided. So, tax insurance can provide companies with the same level of comfort as a private letter ruling, and it can be attained a lot faster. The second time I would think about attaining tax insurance is whenever there's asymmetry between the benefit you'd get from taking the tax position and the potential detriment of a tax position. For example, if you're an MLTN or not, [that is,] "more likely than not" or better on a tax position, but you're not going to take it because of an outsized liability, that would be a good time to think about obtaining tax insurance. And I can give you an example. A close tax colleague was speaking about working at a large internet company, and they were struggling with whether or not a check-the-box election needed a business purpose. He had a Big Four accounting firm at a "should" level of cover and a law firm at a "should" or maybe even a "strong should." So, they were very certain that they didn't need a business purpose, but there were other things going on in the transaction, and the tax benefit would be about \$150 million, but the potential detriment due to a foreign tax credit splitter issue would be about six times that amount, so it'd be \$900 million. So, while they were seventy percent right on the merits, due to running that up the finance chain and having finance people thinking, "Well, is the expected value of loss really potentially \$300 million? Is it \$150 million? Is this worth doing?" In fact, due to the outsized liability, the company didn't end up taking the position. With tax insurance, they could have spent \$20 to \$30 million on a policy to cover their downside risks and still save their company \$120 to \$130 million. So, I think that's the area where we really see a lot of growth in the product and a lot of companies thinking about using tax insurance to protect their balance sheet in the ordinary course of business. I have never met an audit manager who wouldn't gladly settle an issue under audit for two to four cents on the dollar. So, it's worth knowing going in that you can get that comfort up front with tax insurance.

**Harty:** I think that the need for tax insurance is increasing along with the awareness of the product. As new legislation is enacted, as increased funding for the IRS goes into effect, as complexity grows on tax issues—tax issues are always complex, but the complexity is increasing—I think there's an increased need for insurance, which is creating more market awareness. Folks are hearing about it more, and they're beginning to learn about it. The awareness is growing, but the familiarity with the product is very limited; there's not a lot of knowledge as to how it works and what it involves. The process remains mysterious to some, as well as the implications. I think programs like this and getting the word out are really important for people to understand it. I think we're going to see, and we are seeing, increased submissions in the market from a number of participants, which is ultimately a very good thing. But the market itself is also being tested, I think, because the volume and the complexity of risk that is hitting the market is pretty significant. In my view, the market has risen to the occasion. I think that what companies are going to find is that you have a very dynamic and commercial marketplace that will meet their needs at pricing that is very attractive. The product should be very attractive to tax directors and other market participants. In my view, taxpayers and market participants should be encouraged by the opportunity that they have, and I think the market itself will continue to grow.

**Levin-Epstein:** Michael, you have the last word.

**Saitta:** I think we've touched on a lot. In conclusion, that increase in awareness of the product and the increased breadth of what the product can cover is critical. So, I would encourage and challenge any taxpayer (business or individual) who has a potential tax matter, or risk, or some tax position that they think may be a fit for insurance to take it to folks like the CAC team to get their assessment and transform it into a submission that the insurers can consider. The more that we are able to continue this expansion and grow the market, the more we are able to improve the policy and develop the tools that can adapt the policy to a wider swath of fact patterns and tax positions, the more we can continue to have beneficial results. I think the market will continue to improve and continue to provide favorable outcomes for the insureds. We are ready to consider new risks, different risks, and ready to look at things in a lot of different ways. So, the more that can be brought to the market continuing that trend of expansion will, in turn, I think greatly benefit the insureds who take out these policies. ♦