VIEWPOINT

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Inside the Black Box: An Underwriter's Perspective On Tax Insurance

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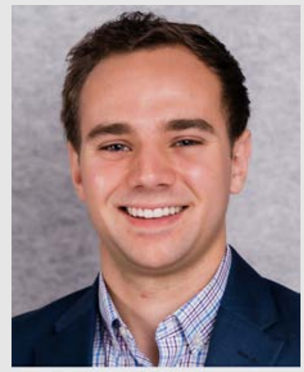
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In this article, the authors examine the factors that tax underwriters consider when determining what policy terms to offer, if any. They also outline the benefits of tax insurance, the process for obtaining insurance, and common policy provisions.

Tax insurance is a cost-effective tool for taxpayers to protect themselves against losses arising from the failure of an identified tax position to qualify for its intended tax treatment. The scope of insurable issues is broad and includes not only U.S. federal tax issues but also state and local tax issues and issues of foreign tax law. It is unsurprising, then, that a rapidly increasing number of taxpayers — from public companies to individuals — are incorporating tax insurance into their routine tax planning and risk management strategy.

This article briefly outlines the benefits of tax insurance, the process for obtaining insurance, and common policy terms. Then, it turns to its main focus: factors that underwriters consider when determining whether to offer terms, and what terms to offer, for tax insurance opportunities.

Tax Uncertainty and Insurance

Although the tax law comprises an immense body of statutes, regulations, and interpretive guidance, it often fails to provide certainty when applied to a taxpayer's particular set of facts. For example, uncertainty may arise regarding the treatment of a unique financial instrument as debt or equity. Or it may arise regarding the application of the step transaction doctrine to a series of transactions. Further uncertainty may arise from potential disagreement about questions of fact — for example, the value of property exchanged in a transaction or the composition of shareholders of a public company.

It can be costly for a taxpayer to face this uncertainty. The most obvious cost is the potential for unexpected tax liability if the IRS (or, if applicable, the state or foreign tax authority) mounts a successful challenge to the taxpayer's position. Most taxpayers cannot easily absorb an unexpected tax liability of tens or hundreds of millions of dollars. Tax insurance allows them to efficiently transfer this risk to the insurance market.

In addition to this obvious cost, tax uncertainty leads to numerous more subtle costs. If the target of an acquisition faces tax uncertainty, the buyer may demand that the seller provide an indemnity or hold funds in escrow pending its resolution. If the potential tax liability is large relative to the value of the deal, tax uncertainty may even cause the parties to walk away from the deal entirely. Outside the mergers and acquisitions context, a taxpayer may need to record a reserve on its books, potentially hurting share price. Or a taxpayer may be dissuaded from implementing a structure that is expected to result in tax savings but that carries a small, but significant, downside risk — especially when that downside risk may lead to a shareholder derivative lawsuit. While these costs individually may not be as disastrous as the sudden obligation to write a sizable check to the government, they may be more detrimental in the aggregate because they arise from the uncertainty itself — not from enforcement — and as such are borne irrespective of whether the tax authority ever audits the taxpayer. Tax insurance is an especially good solution to this problem, because it goes beyond simply shifting these costs from the taxpayer to the insurance market. By eliminating the underlying uncertainty, tax insurance actually eliminates these costs entirely, creating economic value.

Process Overview

At a high level, the process for obtaining insurance involves five major steps. First, the taxpayer reaches out to a specialized broker, who works with the taxpayer to create a submission for the underwriters that describes the tax risk and compiles supporting materials, including any advice that the taxpayer has received from its counsel. During the second step, which typically takes between two and five days, the underwriters evaluate the submission and provide nonbinding indications letters of coverage ("quotes") that outline the anticipated terms of insurance to be offered. Unless a material, unexpected discovery is made during underwriting, these terms — including price — typically represent the final terms of the policy.

The third step involves the taxpayer reviewing the terms offered with the help of the broker, and then selecting an underwriter. The fourth step is formal underwriting, which typically takes around one to two weeks but has been completed in as little as 48 hours. Most underwriters will engage an outside tax adviser to assist with this process. Additional documents will often be requested, and the underwriter may request a brief call to discuss the tax position with the taxpayer and its adviser. During that time, a bespoke insurance policy will be drafted to address the insured risk. Once underwriting is complete and the policy is finalized, the fifth and final step is to bind coverage, at which point the risk is officially transferred to the insurer.

Common Policy Terms

This section briefly describes common terms of a tax insurance policy, though each tax risk is unique, and the insurance market can craft creative solutions to provide taxpayers with the coverage that they need.

Policy period and claims. Tax insurance policies are claims-made policies; therefore, claims are covered so long as they are made during the policy period. A claim occurs upon receipt by the taxpayer of:

- a notice of deficiency, adjustment, or assessment;
- any other form of notice that asserts that the insured tax position is invalid; or

- a request to toll or waive the statute of limitations.

The policy period, typically seven years from inception, is intended to cover the entire period during which the taxpayer could reasonably have a claim regarding the insured tax position. Seven years covers the six-year IRS statute of limitations for a substantial understatement of income, plus one year to account for the fact that the policy may bind before the taxpayer files the relevant return. If needed in specific circumstances, the policy period may be extended up to 10 years.

Limit of liability. The tax insurance market entertains a wide range of submissions and can offer limits as low as around $5 million and as high as $1 billion or more.

Retention. As with traditional insurance, tax insurance policies typically pay when loss exceeds the policy's retention. In some cases (discussed below), the retention may apply only to the costs associated with defending a challenge to the insured tax position ("contest costs").

Premium and underwriting fee. Insureds pay a nonrefundable underwriting fee at the start of formal underwriting, which is typically around $55,000. At inception of the policy, the insured makes a one-time payment of premium (as well as any related surplus lines or other applicable excise taxes).

Loss. Covered loss generally includes additional taxes, interest, penalties, and contest costs, as well as gross-up if additional tax is owed on the receipt of insurance proceeds by the insured.

Standard exclusions. The four standard exclusions in a tax insurance policy are generally quite narrow. The first applies to loss resulting from fraud or a materially inaccurate statement, act, or omission by the insured. The second applies to loss resulting from the insured taking a position on its return that is inconsistent with the insured tax position. The third applies if the insured settles with the tax authority without the insurer's consent (with such consent not to be unreasonably withheld). And the fourth applies to the extent that a prospective change in law (that is, statute or regulation) adversely affects the insured tax position. Notably, loss arising as a result of a retroactive change in law — that is, a change in law that occurs after the policy is bound but applies to a prior tax period — is not typically excluded. Additional exclusions may apply depending on the facts and circumstances of a particular risk.

Approach to contests. Tax contests are led by the taxpayer and its advisers, and the cost is borne by the insurer. The insurer has broad information and consent rights but generally takes a passive role in the process.

Payment of loss. Payment of loss is made following an adverse resolution, which is typically after a final decision by a court of appeals or settlement with the insurer's consent. It is typically not contentious, because the amount of loss is clearly determined by judgment of the court or by settlement agreement.

Considerations for Terms

Because each tax risk is unique, many factors play into the underwriter's determination of whether to offer terms, and what terms to offer, for an insurance opportunity. The primary factor in determining appetite for the risk is the strength of the taxpayer's position, which depends on the taxpayer's facts and circumstances and thus does not lend itself to discussion in generality. Nonetheless, numerous additional factors play into the calculus and can be discussed in the absence of a particular tax risk. This section discusses several of these factors, noting that the relative importance of these factors varies case by case.

Quality of Advice From Taxpayer's Counsel

Typically, taxpayers receive advice from their own advisers before pursuing insurance. The more comfort that this advice provides to the underwriter, the better the terms offered (including a lower premium). Borrowing from a familiar standard in administrative law, the value attributed to the taxpayer's advice "will depend upon the thoroughness evident in its consideration, the validity of its reasoning, its consistency with earlier and later pronouncements, and all those factors which give it power to persuade."[1]

[1] *Skidmore v. Swift & Co.*, 323 U.S. 134, 139 (1944).

Circular 230 opinions are the gold standard of tax advice. They carry significant weight because they reflect counsel's most thorough research and most rigorous analysis. They are also typically issued only after review and approval by a committee of partners and so reflect the judgment of the firm at large.

Next in priority are significant memoranda. These documents do not carry the same imprimatur as opinions, but memoranda that reflect significant research and contain thorough discussion of the issues — and in particular address potential or perceived weaknesses in the position — can nonetheless help a taxpayer obtain favorable terms for insurance.

After significant memoranda come brief memoranda and less comprehensive advice. Although stronger advice helps facilitate the underwriter's evaluation of the risk and is, in turn, generally rewarded with better terms, underwriters routinely consider submissions for insurance supported by issue outlines or annotated transaction step decks. No matter the advice provided, the underwriter will always perform its own evaluation and make its own determination about the merits of the taxpayer's position.

Tax advice generally conveys an attorney's conclusion about the likelihood that a tax position will be upheld if challenged by the tax authority. The tax insurance market will generally consider submissions in which the taxpayer's counsel concludes that the position would at least "more likely than not" (that is, greater than 50 percent) survive a challenge. If taxpayer's counsel is more confident, the opinion may conclude that the position "should" or "will" survive a challenge. These standards are not explicitly defined in the tax code or Treasury regulations, and many practitioners disagree on their precise application, but the general consensus is that "should" corresponds to at least a 70 percent chance of success and "will" corresponds to at least a 90 percent chance of success. Unsurprisingly, a tax position supported by advice at a higher level of comfort will generally be less expensive to insure.

One thing to note, though, is the interaction between comfort level and formality of advice. Underwriters generally take comfort level more seriously when it is attached to more formal advice — that is, an opinion with a "should" level conclusion carries significantly more weight than an outline that states that a position "should" be sustained. This is true not only because an adviser's conclusion is due more respect when it is the result of more significant analysis, but also because law firms stake their reputations upon the accuracy of their opinions and so do not take comfort-level determinations lightly in that context.

Another important factor contributing to an opinion's "power to persuade" is the expertise of the author. Underwriters look to see that the taxpayer's advice comes from a reputable subject matter expert. Often this means advice from a big law firm or one of the Big Four accounting firms, but that is not always the case. For example, if the taxpayer is seeking insurance for an issue of Wisconsin state income tax, it is preferable to have advice from small or midsize local counsel specializing in the area than from a big law federal income tax expert advising on a one-off SALT issue.

Finally, context matters. Although the tax insurance market routinely reviews submissions with advice that is prepared for the purpose of obtaining insurance, underwriters generally prefer to see advice that is obtained in the ordinary course of business. Ordinary course advice tends to take a more balanced view of the issues, because it is prepared for the purpose of helping the taxpayer determine whether to take the position in the first instance. Advice prepared for the purpose of obtaining insurance, on the other hand, often emphasizes the strengths of the position and minimizes the weaknesses. Most underwriters are former tax attorneys themselves and can easily distinguish a neutral discussion of risk from a piece of advocacy. Receiving the latter can be cause for concern, because it may indicate to the underwriter that there are aspects of the risk that are not fully presented.

Procedural Posture and Risk of Detection

Many taxpayers mistakenly believe that a tax position can be insured only before it is audited. In fact, there are opportunities to obtain insurance for positions that are under audit, at IRS Appeals (or the state or foreign equivalent), and even in litigation. Nonetheless, it is typically not wise for taxpayers to wait for an audit (or a 30- or 90-day letter) before seeking insurance, because insurance becomes significantly more expensive once these procedural milestones have been met. Although underwriters insure only positions that they are confident will be sustained against a challenge by the tax authority — that is, they are not in the business of playing "audit roulette" — the practical risk of an adverse resolution increases when the taxpayer's position is identified on audit, and as it proceeds through the controversy process.

Other factors that affect the risk of detection or audit may enter the calculus for terms as well. For example, tax positions with high visibility, such as positions that arise in connection with a newsworthy transaction or that are the subject of an audit campaign, may be more costly to insure. So too may positions that are subject to disclosure as an uncertain tax position or because of a taxpayer's participation in the IRS's compliance assurance process. At the extreme end of this spectrum are listed transactions (for example, syndicated conservation easements) which, along with tax shelters and transactions that lack business purpose, are not insurable.

Context and Motivation for Insurance

Historically, tax insurance has been used in M&A to help facilitate deals when tax issues were identified during diligence. Representation and warranties insurance, which covers losses arising from breaches of the seller's representations and warranties (including tax representations), typically excludes from coverage any tax issues that are known to the parties. Tax insurance has traditionally been used (and continues to be used) to help fill this gap. Recently, however, tax insurance has expanded significantly, and taxpayers are wisely seeking insurance outside the M&A context.

Many underwriters believe that this is an enormous opportunity and that tax insurance should be part of every large taxpayer's routine tax planning process. In some ways, insurance outside the M&A context may be less expensive than in connection with a deal. Many M&A tax policies are buy-side policies, and the buyer may have limited knowledge of — and thus limited ability to represent — the accuracy of relevant facts. This issue does not arise in the context of internal or strategic tax planning, which reduces the risk that factual inaccuracies will arise to the detriment of the insured tax position. This lower risk may in turn translate to a lower cost of insurance. At the same time, the difference in context raises a question of motivation. In the M&A context, the motivation for insurance is often straightforward — the buyer is not comfortable with a tax position taken by the target or seller. This dynamic does not exist when only one party is involved, so the taxpayer's motivation for seeking insurance is not always clear. If the position is old and cold, the underwriter may wonder why the taxpayer is seeking insurance now. If the taxpayer is seeking insurance contemporaneously with deciding whether to take the position, the underwriter might wonder whether the taxpayer would take the position in the absence of insurance. If the taxpayer can bolster the underwriter's confidence by explaining its motivation for seeking insurance, it may be rewarded with better terms.

Jurisdiction

In addition to the United States, the United Kingdom and EU both have sophisticated tax insurance markets. Generally, underwriters are most comfortable with (and have the strongest relationships with advisers that specialize in) risks arising under the laws of their local jurisdictions. As a result, foreign tax risks tend to be more costly to insure than domestic tax risks. However, the applicability of this general rule varies significantly with the foreign jurisdiction. Tax risks in jurisdictions with a strong rule of law and healthy body of interpretive guidance, such as Canada, may see little difference in pricing compared with their domestic counterparts. On the other hand, tax risks in jurisdictions with high levels of corruption or patterns of governmental overreach (for example, threatening criminal sanctions to pressure taxpayers to settle or prohibiting counsel from accompanying taxpayers to hearings) may be significantly more expensive or not insurable at all.

Nature of the Risk

Tax risks generally fall into two broad categories: "binary" risks and "non-binary" risks.

Binary risks involve an all-or-nothing resolution, with the taxpayer being either fully entitled to the tax position or not entitled to the position at all. For example, whether a spinoff qualifies for nonrecognition under IRC section 355 is a binary risk. On the other hand, non-binary risks involve the possibility that the taxpayer's position may be adjusted by the tax authority to varying degrees. Risks involving valuation, such as tax owed on a distribution of property in kind, are examples of non-binary risks.

While no risk is truly binary — there is always the possibility of settlement with the tax authority, especially regarding interest and penalties — a higher premium is likely when the insurer's last dollar of limit is subject to materially the same risk as the insurer's first dollar, compared with a risk for which the insurer's last dollar of limit will be paid out only if the tax authority sustains an extreme adjustment. The nature of the risk also plays a role in determining retention. Insurance for non-binary risks typically incorporates a traditional retention (that is, a retention that applies to all elements of loss). Insurance for binary risks, on the other hand, often incorporates a retention that applies only to contest costs, so the insurer pays the first dollar of tax in the event of an adverse resolution.

Cost to Underwrite

Most underwriters will engage an outside tax adviser with subject matter expertise to assist in analyzing the merits of the insured tax position. To defray these third-party costs, underwriters charge a small underwriting fee in addition to the insurance premium. Although this fee is generally not significant compared with the premium, it may vary with the third-party costs required to underwrite a policy.

For example, some tax positions face potential challenge not only on legal grounds but also on factual grounds. Consider a transaction in which a U.S. corporation is acquired by a foreign corporation in a stock-for-stock deal. Whether this transaction is caught by the anti-inversion rules of IRC section 7874 may depend not only on questions of law (for example, whether some shareholders are ignored for purposes of the inversion analysis) but also on questions of valuation (in particular, the value of the U.S. target relative to that of the foreign acquirer). In that case, the underwriter may retain a valuation expert in addition to a tax adviser to analyze the risk.

As a second example, consider a scenario in which the owner of an S corporation is seeking to insure its S corporation status. Without a buyer in the picture, no third-party diligence may be procured. As a result, the underwriter and its tax adviser must conduct the primary due diligence, potentially leading to a higher underwriting fee.

Conclusion

As each tax risk is unique and each tax insurance policy bespoke, numerous factors play into the underwriter's determination of proposed coverage terms. This article seeks only to give an overview of some common factors and does not attempt to (and indeed could not) provide an exhaustive list. This article also highlights that a wide range of tax positions are insurable, so when in doubt, taxpayers should explore the possibility of insurance. As a rule of thumb, taxpayers should think about insurance whenever they would consider reaching out to their tax counsel for advice. While the terms offered and price of insurance may be the subject of a complex calculus, the price to obtain quotes is easy to determine — it is always free. ■