Lowenstein Sandler's Insurance Recovery Podcast:
Don't Take No For An Answer

Episode 49
Tax Liability Insurance Products: A Hidden Gem in the Transactional Lawyer's Tool Box

By Lynda Bennett, Justin Berutich, Yoav J. Shans

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Lynda Bennett: Welcome to Don't Take No for an answer. I'm your host, Lynda Bennett, Chair of the insurance recovery practice at Lowenstein Sandler. And today we're going to be talking about a very interesting topic, what I like to call a hidden gem in a transactional lawyer's toolbox, and that is tax liability insurance products. Over the last couple of years, a number of my corporate partners have talked about and gotten comfortable with using reps and warranties policies, and have become more interested in finding ways to move certain risks and potential liabilities out of the deal transaction. And so they've heard a bit more about tax liability policies.

So today I'm very pleased to have two special guests who are working with these policies day in and day out. Yoav Shans, a partner and head of tax at McGill + Partners. Welcome, Yoav.

Yoav Shans: Thank you. Happy to be here.

Lynda Bennett: And also I've got Justin Berutich, who is the head of tax at Euclid Transaction. So Justin, thank you for joining us as well.

Justin Berutich: My pleasure, Lynda. Thanks for having me.

Lynda Bennett: All right. So why don't we jump right in. Tax liability insurance policies have been around for quite a while. So why is this relatively mature product one that seemingly not many people have known about until the last couple of years?

Yoav Shans: I'm actually really happy about the way that you phrased that question, that it is a mature product, because indeed it is matured, is not a beta version. And you hit it on the head, there is a knowledge gap. I think there's a knowledge gap in the industry, and not just the tax industry, the business community at large. You could break it up into several buckets. You have people that just

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don't know about the fact that the solution exists. In fact, a lot of conversations that I have, there are people who are surprised about tax insurance. They think that I'm referring to the tax protection that's covered by reps and warranties policy. But when we get into it, they're like, "Oh, this is a separate product." And they didn't know about it.

There's another group of people that maybe have heard of tax insurance, but don't fully understand it or don't know how to think about it. So perhaps they think that the solution doesn't apply to their situation, or they think that it's too expensive, or they think that it's taboo, or that it's signals that the position is weak. Or maybe they just don't believe in insurance, they don't think that it's going to pay out, which is not true. That's a misconception. So we'll get into that as well.

And then of course, I think one of the major issues is there are certain tax advisors who may think that we're in competition. There is this internal conflict, if you will. If a tax advisor is giving you their opinion, they're doing the analysis, they're giving you their advice, there's a perceived conflict in then saying, "Hey, you should also get insurance for this risk or for this issue," which is not the case.

Technical accuracy is one thing. Risk mitigation is something different. We shouldn't confuse the two. And in fact, the tax advice, the opinion of a law firm or an accounting firm is a requisite for tax insurance. And so the two products, the two solutions really are complimentary of each other and are not in competition. So there's a lot of reasons why tax insurance isn't as widely known. But I think we're closing that gap.

Lynda Bennett: Oh, and I love your comment on the conflict because anyone who's completed their own personal income tax return knows there's more gray than black and white in the tax code.

So Justin, why don't you tell us what the purpose of these tax liability policies are. And maybe give our listeners a couple of examples of typical scenarios where a company does or at least should consider a tax liability insurance product.

Justin Berutich: Sure. Thanks, Lynda. Tax insurance is a protection tool for private equities, strategics, individuals, and virtually any other tax payer should a tax physician fail to qualify for its intended tax treatment. And when does it or should it be considered? The line I like to send people away with is anytime a tax payer seeks tax advice from his tax advisor or walks down the hall and talks to their in house tax folks, that's an opportunity for tax insurance.

And in a broader sense, tax insurance falls into three main buckets. M&A, and that can be a historic risk at the target company or the structure of a current deal. It can be a strategic position taken by a taxpayer outside of an M&A transaction. Is that instrument debt or equity? Is the new comp plan that we put in place 409A compliant? And then the third category is tax credits. We typically see that in the solar and wind space with ITCs and PTCs, but we can also cover other things such as historic tax credits, 45Q and the like.

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Lynda Bennett: How customized are these tax policies? We've said they're a mature product, but are there "off the shelf" policies that you're getting, or is each deal different and the terms and conditions customized for the specific transaction?

Justin Berutich: All policies are bespoke for that specific tax risk. But with that said, we have experience in dealing with a lot of tax risks that we see over and over again. And we'll draw on our experience from other tax risks to help streamline the process.

Lynda Bennett: And Yoav, how negotiable are these bespoke policies when we start to get into the terms and conditions? How much back and forth is there to get the words right?

Justin Berutich: There's a considerable amount of back and forth. A lot of the provisions, the wording absolutely does matter. And so there is a negotiation that goes into crafting each policy and making sure that it applies as completely as it could be to the particular situation. But obviously some other provisions are not. For example, the fraud exclusion is not something that you could change in any way. I mean, there are some protections for the insurers. Those are reasonable and they make sense, they're commercial. So some provisions are not as negotiable as others.

Lynda Bennett: And is there one type of policy? Justin just listed off a couple of different ways in which these policies have been used? Yoav, are you seeing any one in particular standing out as the one that people are coming to you most frequently to place?

Yoav Shans: No, I would say it's all over the board. And in fact, to add to what Justin had said previously, I mean, we are talking about M&A, and so I think M&A implies two third parties on either side of the transaction. It's not necessarily M&A. The transaction could be entirely internal. So you could do a transaction in anticipation of an M&A deal. You need to either package a business or clean it up. You could do a transaction after you have just acquired something, and so you need to break it up and then put the puzzle pieces back together again and integrate this business into your own structure. And so both of these situations that I just described, they're purely internal and they're effectively internal M&A, where tax insurance is still also an opportunity.

And then even further, just to make it clear, we're not only talking about us taxes or even us federal income taxes. There's also state income taxes. There are indirect taxes. There are non-US taxes. Positions that are currently under audit, again, whether in the US or not could be insured. Transfer pricing is something that we're talking about a lot. The opportunities are endless. Tax is a global concept. It's sector agnostic. And so the applications are really broad.

Lynda Bennett: That's great. And you mentioned earlier that there's some confusion in the market as between tax policies and the tax coverage offered through a rep and warranty policy. Can you comment briefly on what the difference is

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between a tax policy and what the protection is in a rep and warranty policy on tax issues?

Yoav Shans: Sure. So I think it's easier to start with tax. So tax insurance looks at a particular position, and the relevant parties know that there's risk and there's uncertainty with respect to that one position. And so we contractually transfer that risk to an insurance company. And so should the risk materialize, the parties know that an insurance company is going to cover the bill.

And so it's out, as we talked about, it's not necessarily tied to the M&A contacts. It could be a historical issue. It could be an issue of the transaction that we want to execute right now. Could also be forward-looking. And so one example would be in an S corp. When you buy an S corp, you make the 338(h)(10) election, you get a step up. And the value of that step up is predicated on incremental depreciation, amortization deductions that you would get in the future. And so those future deductions, or I should say the value of those future deductions could be protected by an insurance policy. So that's tax insurance.

The tax coverage that's offered by a reps and warranties policy is different in several ways. And the first is it is limited to the M&A context. So you have to have two third parties, you have to have a seller that is providing representations and warranties to a buyer. So that's the first distinction.

The second is the loss or the tax issue that may arise has to relate to a pre-close issue. And it also has to be a risk that isn't as fairly known. So if it's a known risk, the theory is that the parties who are negotiating at good faith know about the risk. And so that risk will be priced into the deal. Therefore, the insurance company is not going to cover you for that particular risk.

Whereas in tax, it's everyone knows about the risk, and that's exactly what we're insuring. In a reps and warranties policy, it's those unknown risks that we don't know about that they materialized post-closing. Of course, that relates to a pre-close period that we're insuring.

And then finally, you have to, in a reps and warranties policy, tie the loss to a breach in one of the representations, whereas in a tax policy, essentially when the tax position is successfully challenged by a tax authority and the client gets assessed a tax, that's when the insurance policy pays.

Lynda Bennett: That's great. Thank you, Yoav. So Justin, now our listeners are keenly interested in these great policies that are going to solve all of their tax issues or give them sleep at night insurance. So why don't you walk us through what is the underwriting process for a tax liability policy? What information needs to be provided? How long does it take? What does the pricing look like? Just sort of walk through the process.

Justin Berutich: Sure. I will couch everything I'm about to say in generally and facts and circumstances dependent. But typical pricing on a tax insurance policy is going to be a one time payment of 2 to 4% of the amount of coverage they're purchasing or limit that they're purchasing. And we typically have retentions as low as 100 or $150,000. If the tax risk is binary, meaning that it's either

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correct or incorrect, the retention may only apply to contest costs or the cost associated with defending the position.

The timing on getting a policy done, I typically say that it takes about 14 days from soup to nuts. So when you reach out to Yoav and say, "Hey, I would like to bring this to market to when you select me and then I bind you a policy," that's typically 14 days. However, we're all former deal attorneys or deal advisors, and we can get things done on an accelerated timeline. I've gotten a policy done in 48 hours, obviously not ideal, but we had to get everybody on board working together and we were able to accomplish that. And your other question was...

Lynda Bennett: Just what information? So what's the volume of information? What are the key documents that people are going to have to have gathered to move that quickly?

Justin Berutich: Yoav and McGill and his colleagues, they will help you craft the submission. Typically, it's going to involve some sort of advice from your tax advisor. That does not have to be a tax opinion. It can be a memo. It can be an email with advice. It could be contemporaneous, or it could be put in place historically, some sort of advice that gets us up to speed on what that risk is. And potentially some supporting documents at the submission stage.

We will then do our best to provide our terms. Those terms will be reviewed by the taxpayer, insured, and their broker. And once you select an underwriting market like myself, then we might dive into more of the details, get all the specific documents that were previously mentioned, run it down with the council that we'll bring in as well. And during that whole process, we're going to negotiate the policy that we discussed earlier.

Lynda Bennett: And once you've moved past the indication of interest, is there a fee once the insurer is bringing their lawyers into the deal to take the closer look?

Justin Berutich: There is. There's typically a non-refundable underwriting fee, somewhere in the range of 40 to $65,000, depending on the risk. They can go up, they can be less, but that's typically where we see them. And that's the only cost upfront until the policy is bound, at which point the premium or a deposit on the premium is then due.

Lynda Bennett: Great. So Yoav, has the tax insurance market been impacted by the volatility the insurance industry is feeling across some of the other coverage lines like DNO and cyber? What are you seeing in terms of pricing and competition?

Yoav Shans: So as a general matter, I think the answer is no, not in my experience. The market has been pretty good. We did not see the spikes that reps and warranties and DNO and other, including cyber, have experienced. And so that's a good thing.

I think that we all have our job to do. We need to be careful and make sure that certain risks that shouldn't get insured, don't, because we don't want something that spoils it for everyone else, and all of a sudden we have pricing go way up.

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And I will also say that that 2 to 4% range that Justin mentioned, which is true, and then the rest of that conversation about underwriting, I think that does highlight the value of a good broker because the timing of the underwriting, how long that takes, and of course the pricing. If you have a really good broker that can anticipate questions that dive into the details, could help you with that submission and crafted and make sure that they position the risk the right way, that really does make a big difference. And so in our experience, the pricing, we have not seen a significant spike in pricing.

Lynda Bennett: That's great. All right, well, we've just got a couple of minutes left here. So Justin, I'll throw it to you. Are there any types of deals or issues that are not a good fit for tax liability policies from your perspective?

Justin Berutich: So we're not tax shelter insurance. We're only going to insure things with substance. And so we're typically not going to do reportable transactions. We're not going to do tax shelters or structures designed solely to avoid taxes. And then it's also very difficult for us to do anything related to a future change in law. And what we deem supportable in the industry is typically a position more likely than not or stronger. And so substantial authority and things of that nature are very difficult to get insured.

Lynda Bennett: Okay, great. And Yoav, just in the last couple of minutes we have here, what's the most important thing that the policy holder has to have a good handle on before they come to you and then you take their risk to market when they're looking for a tax liability policy?

Yoav Shans: I would say in order to use tax insurance to its fullest potential, what you would want to do is use tax insurance as a proactive measure. So we have done it on several occasions that we went to the insurance market and we were able to get terms for insurance without the analysis. And so obviously those terms were contingent on that analysis, whether it's a memo or an opinion or something else. They were contingent on receipt of that analysis, but the analysis didn't exist at the time.

And so think about it from a business or from a commercial perspective. The company was trying to do something, whether it was an M&A transaction or just internal tax planning, they were trying to do something, and they were at the go, no go decision phase. So this was really, really early. And they were able to make a more informed, better business decision because they had the benefit of a tax insurance policy rather than considering just the tax risk.

And so to really squeeze the most juice out of tax insurance, contact your brokers, contact me as early as possible.

Lynda Bennett: All right. Great. Well, thank you both very much for pulling the curtain back on this really excellent risk transfer insurance product that's out there. Really appreciate your knowledge and your insights and your time today. So thanks for joining us.

Yoav Shans: Thank you.

Justin Berutich: Thanks Lynda.

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