Tax Liability Insurance: A Game-Changer in Addressing Tax Uncertainty

A survey conducted by KPMG[1] with 500 chief executives shows that tax risk has risen to become the second-greatest threat to growth for businesses over the next three years.

In addition, finance ministers from the G7 nations recently agreed on a landmark deal to establish a global minimum corporate tax rate of at least 15 per cent.

Hence, going forward, tax liability will become a significant cost for businesses that has to be closely monitored. This, together with the increasing complexity in tax legislation and tax policy design, will have a huge impact on how businesses assess tax risks relating to cross-border M&A transactions going forward.

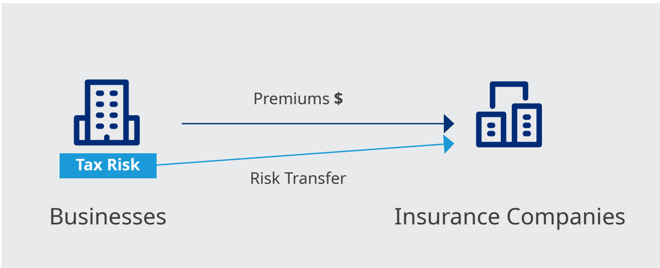
As a result, businesses may look for innovative solutions, such as tax liability insurance, to manage their tax risks. Across Asia, we have seen a growing interest among clients to use tax liability insurance to manage their tax risks and have assisted many of them to obtain these policies.

We have highlighted below some frequently asked questions about tax liability insurance, common misconceptions about the product and a few case studies on how our clients have successfully used tax liability insurance to manage their tax risks.

Definition of tax liability insurance

Tax Liability Insurance is an insurance solution for the insured to transfer specific and identified tax risks to the insurance markets.

With a tax liability insurance in place, the insured will be able to claim any financial losses suffered from the insurers should the tax authorities seek to impose taxes on the insured tax risks.



Items covered under a tax liability insurance

The product provides coverage to the insured against losses arising from the insured tax risks, which includes:

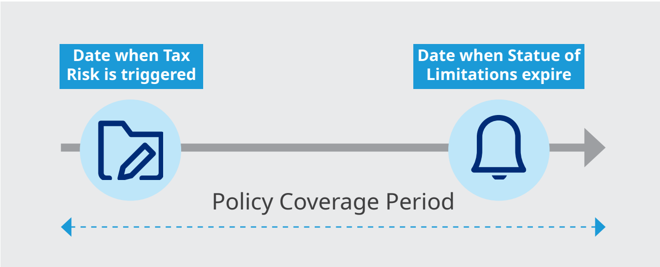
- Tax liability imposed by the tax authorities, inclusive of interest and penalties.
- Defense costs incurred by the insured to engage tax advisors to defend against a challenge from the tax authorities.
- If the proceeds received by the insured from the insurance is subject to tax, the policy can also cover such taxes that has to be paid by the insured (i.e. tax gross-up).

In addition, tax liability insurance also includes an advance tax payment feature where the insurer can make tax payments on behalf of the insured at the onset if the payments have to be made in advance (and cannot be deferred or postponed) before an appeal can be pursued.

[1]https://home.kpmg/xx/en/home/insights/2021/03/ceo-outlook-pulse.html

Period of cover

The period of cover is flexible and is decided by the insured. The insured will usually require a policy period that will mirror the statute of limitation of the jurisdiction where the tax risk is located.



For example, in Thailand, the statutory time limit for the Revenue Department to raise an assessment or additional assessment is ten years. Hence, for Thailand tax risks, the insured will generally request for a policy period of ten years.

Situations where tax liability insurance can be used

Theoretically, a tax liability insurance can be used in all situations as long as there is a specific and identified tax risk that the taxpayer would like to seek coverage on.

M&A Transactions

Based on our experience, we have seen tax liability insurance most commonly used in M&A transactions. When negotiating a deal, it is to the buyer's interest to take the most conservative view on all tax risks (although the risk may be low / remote) and request specific tax indemnity from the seller for any potential tax risk, which may be unnecessary.

If the seller provides such indemnity, it will need to hold back cash for the potential tax liabilities and will not be able to distribute this cash to the investors. Such need (to hold back cash) will affect the return on investments, therefore, tax indemnity is usually negotiated extensively between both parties and may hold up the transaction. To speed up the negotiation, tax liability insurance can be used by sellers to back an indemnity or taken up by buyers when their sellers are unwilling to stand behind the potential liability on specific tax issues. As insurer will be the one liable for any potential tax liabilities, neither the seller nor the buyer will be taking on the tax risks.

Bridging the gap between seller and buyer

Hence, the main benefits of obtaining a tax insurance in an M&A transaction include:

- Unlock cash and increase returns on investments.
- Speed up the deal execution process.

Corporate Group Restructuring

Outside of M&A transactions, we have also seen businesses used tax liability insurance to cover tax risks that may arise as a result of a corporate group restructuring. If a potential tax risk is identified during a corporate group restructuring, businesses can obtain a tax liability to cover this potential tax risk so that they can proceed with the restructuring process without having to worry about any tax liability that may arise in the future.

In certain countries, it may be possible to write in to the tax authorities to seek an advance ruling on the tax outcome before businesses undergo the restructuring steps. In this way, businesses will be able to obtain certainty on the tax exposure and do not have to worry that the tax authorities will challenge the tax risks in the future.

However, seeking an advance ruling from the tax authorities is not a straightforward process. The tax authorities will need time to review all the relevant documents and may have follow up questions before providing a ruling. The whole process may take as long as six months to a year which can delay the whole restructuring exercise. Mostly importantly, there is no guarantee that the tax authorities will come back with a positive ruling.

Instead of seeking an advance ruling with the tax authorities, businesses can consider using tax liability insurance as an alternative to obtain certainty on the tax outcome. The process of obtaining a tax liability insurance is relatively straightforward and often can be completed within four weeks.

Common misconceptions

Two of the common misconceptions about tax liability insurance include:

Insurers will handle challenge from the tax authorities

The insured will still be the party responsible to defend the tax position should there be any challenge from the tax authorities. The insured will need to engage their own tax advisors to draft responses to the tax authorities in relation to any questions raised. However, insurers' approval will need to be sought before any correspondence are sent to the tax authorities.

All tax risks can be covered by a tax liability insurance

A tax liability insurance is only used to cover a specific and identified tax risk. The tax risk is clearly defined in the policy and the insurers will only pay out claims relating to losses incurred on this particular risk.

Further, given that the covered tax risk is a specific and identified risk, the insurers will only underwrite the tax risk if it is confident that the position taken can be sustained. Hence, the insurer will require the insured's tax advisor to provide an opinion which conclude that the risk level is relatively low (also known as a "should" level opinion).

CASE STUDIES

We provide below two case studies on how our clients have successfully used tax liability insurance to manage their tax risks.

Case Study 1: Acquisition of shares in a target that owns infrastructure project in Europe

Nature of Tax Liability Insured
Tax exposure on interest being reclassified as dividends on the basis that the interest rate charged between related parties is excessive.

Background
Our client, (the “Buyer”) was contemplating an acquisition of a SPV which owns an infrastructure project in Europe.

During the tax due diligence, the tax advisor has highlighted the risk that the interest rate charged on the shareholder’s loans borrowed by the SPV may be excessive (i.e. non-arm’s length) and there is a risk that the tax authorities may reclassify the interest to dividends which is subject to withholding tax.

Challenge
Given that this is a hotly-contested asset, the Buyer was not able to seek any purchase price reduction or specific indemnity from the Seller on this tax risk identified. Hence, the Buyer was looking for a solution to transfer the tax risk to a third party.

Solution
Marsh assisted the Buyer to place a tax liability insurance to cover this particular tax risk. With a tax liability insurance, the Buyer was able to transfer the risk to a third party (other than the Seller) and hence, was able to proceed with the transaction with certainty on the historical tax risk identified.

Case Study 2: Transfer of a property between related companies as a result of a corporate group restructuring.

Nature of Tax Liability Insured
Tax exposure on the transfer of a property in North Asia.

Background
Our client, a corporate real estate group (the “Group”) was undergoing a group restructuring in North Asia. As part of the restructuring exercise, the Group is required to transfer one of their properties from one entity to another related entity.

Under the relevant tax law, there is a risk that the transfer of the property may result in significant tax liability for the Group unless certain conditions are met.

Challenge
Given that the potential tax exposure is significant, the Group will require certainty that the transfer will not result in any tax liability. Otherwise, the client will not proceed with the group restructuring and will need to think of alternative plans.

Solution
Marsh assisted the client to place a tax liability insurance such that the client will be able to proceed with the group restructuring with certainty on the tax outcome. With the tax liability insurance in place, the client does not need to be concerned about any tax liability that may crystalize in the future as a result of the group restructuring.

For more information on tax liability insurance, please contact one of the Marsh Private Equity and M&A Practice representatives.

Contacts

Cheow Ai Ling
Asia Practice Leader, Private Equity and M&A Services
+65 6922 8019
ailing.cheow@marsh.com

Eugene Lim
Head of Tax Risk – Asia, Private Equity and M&A Services
+65 8725 5825
eugene.lim@marsh.com

Suparindaporn Wongyara
Head of Private Equity and M&A Services, Thailand
+66 (0) 91 770 4013
Suparindaporn.wongyara@marsh.com