A new way to manage risk

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Richard Taylor explains some of the features of tax liability insurance

Key Points

What is the issue?

The global tax landscape is increasingly uncertain and complex. As attitudes and approaches towards revenue collection evolve, there are often grey areas and ambiguities for taxpayers to negotiate.

What can I take away?

A tax liability insurance policy can be used to protect a taxpayer (or another party) against loss arising from a particular tax event and to provide the certainty required to facilitate commercial activity.

What does it mean to me?

Additional certainty or comfort can be achieved using a tax liability insurance policy in a variety of contexts and so it should be considered as part of prudent risk management.

A tax liability insurance policy protects a taxpayer (or another party, e.g. one that is secondarily or jointly liable) against loss arising from a particular tax event. For example, a taxpayer may treat certain supplies as exempt for VAT purposes. However, a third party adviser might identify a risk that HMRC could challenge the supplies as standard-rated, such that the taxpayer should have registered for VAT and VAT is due to HMRC. In this scenario, a tax liability insurance policy could be sought to give the taxpayer comfort that, even where HMRC does challenge the VAT treatment of supplies, it will not suffer a loss.

The precise loss that can be covered by a tax liability insurance policy is flexible, but typically comprises:

1. the tax payable (in the example above, the VAT);
2. penalties and interest payable to the tax authority;
3. the costs of dealing with a tax authority enquiry, dispute or litigation (‘defence costs’); and
4. any tax suffered by the insured on the insurance proceeds received (‘gross-up’).

Another important feature of tax liability insurance is that cover can be provided for where a tax authority requires payment on account. Certain jurisdictions require an advanced tax payment or guarantee before a taxpayer commences a dispute in respect of a tax assessment; in the UK, an accelerated payment notice requires payment on account. This policy enhancement can prevent cashflow issues or the need to provide for an assessment in a taxpayer’s accounts.

It is important to distinguish between tax liability insurance and its sister product, warranty and indemnity insurance (W&I). Readers familiar with W&I will be aware that it covers unknown risks in respect of the warranties and tax covenants given in the sale documents relating to an M&A transaction. Crucially, identified risks are excluded from cover in a W&I policy (the principle generally is that unknown risks are covered), whereas tax liability insurance indemnifies the insured for an identified risk.

As with W&I, depending on the complexity of the risk, tax liability insurance can be arranged in a relatively short period of time in order to meet the demands of commercial timelines. Depending on the nature of the risk, it is possible to complete underwriting and formalise a policy in five working days from the point at which the insurer is provided with all required documentation and responses to Q&A. However, the process is typically completed within two weeks.

What is insurable?

Tax liability insurance can cover any type of tax in any jurisdiction, with limits of liability ranging from as little as £1m up to hundreds of millions. It is also possible to obtain insurance for both individuals and corporates. Before making an offer of insurance, an insurer will take into consideration whether:

- the position taken is defensible: taking into account the law and the fact pattern, defences should be available with appropriate documentation/evidence to support them;
- a challenge by a tax authority is likely: if the challenge is for a defensible position, this will be factored into pricing;
- the jurisdiction in question upholds the rule of law and has a stable court system that offers legal certainty; and
- insurance is being sought as an alternative to typical prudent behaviour (e.g. instead of maintaining a defence file).

Tax liability insurance is only available for genuine commercial arrangements. Cover is not available for intentional tax avoidance/evasion or marketed schemes.

When can tax liability insurance help?

The use of tax liability insurance is varied and the need for a solution is often identified when transactions or operations are scrutinised by third parties, e.g. in an M&A context or where an adviser risk review is undertaken. The examples below demonstrate how tax liability insurance has been used in the UK to allow transactions to progress, save time or manage risk.

M&A risk management

Where a tax risk is discovered in due diligence, insurance can serve as an alternative to a price adjustment, escrow, indemnity or other contractual protection. Insurance can be used to enhance the protection available to the buyer (i.e. an insurer’s covenant strength may be attractive) or to serve as a shield for the seller (e.g. by transferring the risk regarding an indemnity).

Example 1: Competitive auction process

In a competitive auction process, a bidder identifies a sizeable tax risk during its due diligence. Notwithstanding that the identified position may be defensible, the quantum is material. Instead of making a price adjustment, it may be an attractive proposition to the seller if the bidder proposes to split the cost of an insurance policy. If other bidders have discounted their bids to account for the risk, then this solution may be a differentiator.

Example 2: Vendor due diligence process

A seller preparing for a disposal discovers a tax risk during its vendor due diligence process. In order to mitigate the threat of any price adjustment, the seller could include a policy in the data room dealing with the risk. It may be that the seller is best positioned to arrange the insurance because the seller may have confidential information that assists with underwriting which it is not willing to share with the buyer.

Example 3: Indemnity insurance

A buyer is insisting on an indemnity in respect of an identified tax risk. The seller is willing to give the indemnity, but does not wish to commit capital or desires the freedom to wind-up the selling corporate post-closing. The seller could obtain insurance to sit behind the indemnity and cover its liability.

Example 4: Pre-packaged administration

A tax risk has been identified in relation to a company heading towards a pre-packaged administration. As the acquisition is a pre-pack, there will be no recourse for the buyer. In this scenario, the identified tax matter could be derisked using insurance.

Clearance or ruling

Insurance can be used to provide a quicker and confidential alternative to a tax authority clearance or provide the comfort of a clearance if one is otherwise not available.

Example 1: Reorganisation

A reorganisation for commercial reasons has to be completed in a certain way (e.g. using a capital contribution) and there is time pressure to complete the reorganisation. However, there is uncertainty regarding how the reorganisation steps will be treated for tax purposes. Insurance could be used to confirm the position.

Example 2: Section 75A anti-avoidance

A reorganisation is to be undertaken post-acquisition of a property holding structure, whereby the property may ultimately be de-enveloped. The taxpayer is concerned that the FA 2003 s 75A ‘anti-avoidance’ rule is in point and is advised that a challenge by HMRC cannot be 100% ruled out. Insurance could be used to give the equivalent of a clearance in this case.

Example 3: Phoenix company rules

An individual sold the assets of a trading company to a third party buyer that did not wish to acquire the company and inherit the company’s historic tax position. The individual wishes to wind-up the company and realise the sale proceeds, but wants to be sure that the ITTOIA 2005 s 396B ‘phoenix company’ rules will not apply. As a clearance is not available, insurance could be used as an alternative.

Ongoing risk management

It is possible to use insurance to ensure commercial certainty as part of prudent risk management.

Example 1: Application of IR35

A private sector company which heavily relies on contractors undertakes a review with a third party adviser to assess the impact of the application of IR35 to the private sector. The quantum of the prospective liability is large, such that protection is desirable. Insurance could be used to prevent loss arising from the contractors being treated as employees.

Example 2: UK residence risk

An internal review is undertaken of a corporate structure and identifies a UK residence risk in respect of certain non-UK entities (e.g. where structure paper recommendations have not been followed). Peace of mind regarding the historic and future residence position could be achieved with insurance.

Example 3: Transfer pricing

A real estate investment manager is looking to ensure that its modelling is robust. The model is reliant on the deductibility of interest chargeable on intra-group debt. To achieve commercial certainty, a policy could be bought to protect against a transfer pricing adjustment.

Example 4: GAAR

Notwithstanding that the main purpose of certain arrangements were commercially driven, a taxpayer may have a concern that a tax benefit derived from those arrangements gives rise to a GAAR risk. An accelerated payment notice would have a cashflow impact and require an accounting provision (which may, for example, have a financing impact). The taxpayer could seek insurance with advance tax payment cover to mitigate the effect of an accelerated payment notice.