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THE BASICS OF TAX INSURANCE

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This article intends to equip the reader with a solid understanding of what tax insurance provides, why it is needed today more than ever, how it may be marketed and the need for the industry to remain circumspect in order to achieve continued acceptance by the IRS. This article is an abridged version of the fuller article that can be found at http://www.plusweb.org.

BACKGROUND: COMPLEXITY = UNCERTAINTY = CASH NEEDS

The United States Tax Code is among the most complex tax codes of the entire world. Although the IRS's mission is to provide top quality service in helping taxpayers to understand and meet their tax responsibilities, few taxpayers seek tax advice from the IRS. Moreover, in many instances, the IRS (perhaps quite justifiably) will not provide an advance ruling on a particular tax issue (e.g., the matter is too factually oriented or the law is too undeveloped, etc.).

The result is that taxpayers and tax-reporting entities are often confronted with complex and uncertain tax positions if they engage in even a relatively modest amount of tax planning.

The uncertainty around tax positions can linger (and aggregate) over the course of years and ultimately give rise to a need for cash that could far exceed the amount of taxes in dispute. Each uncertain position will, if taxes are owed, be assessed interest on the unpaid tax, generally for the period beginning on the due date of the return and ending upon payment. The rate of interest is determined every three months and is the sum of the federal short term rate (2.54 percent for August 2008) plus 3 percent. Interest is compounded daily. Each uncertain tax position may also cause penalties to be assessed.

Moreover, penalty provisions have mushroomed. The Internal Revenue Code now has more than 140 penalty provisions. For example, if the taxpayer's position was negligent or in disregard of the rules, 20 percent of the underpayment may be assessed as a penalty. In addition, if the underpayment was "substantial" (more than 10 percent of correct payment), and if the position is not supported by "substantial authority", a 'substantial underpayment" penalty of 20 percent of the underpayment may also be assessed. If the underpayment was supported by a "substantial valuation misstatement" a penalty equal to 20 percent of the underpayment may be assessed and such penalty may be increased to 40 percent if the valuation misstatement was "gross." Moreover, the IRS can assess interest on the penalty assessments accruing as of the date of the return!

Hence, the unpaid tax, potential interest and penalties for each uncertain tax position in each "open" return (i.e., a return that is subject to audit because the statute of limitations has not run) can create a significant contingent liability.

To comply with U.S. GAAP, the contingent liability for uncertain tax positions must now be accounted for in accordance with newly prescribed methods known as FIN 48. The rules require that reserves (charges) be taken for uncertain tax positions. The charges impact retained earnings in the first year of adoption of FIN 48 and will impact current earnings thereafter. Changes to such charges must also be shown in tabular form as tax returns are closed and new tax periods are opened to audit.

These charges essentially broadcast what might be viewed by taxing authorities as a minimum amount to be additionally assessed. Moreover, these charges could cause technical defaults in loan and/or lease covenants (since they impact earnings and future cash flow).

FIN 48 also requires a qualitative description of the tax issues that relate to each tax position that may be significantly changed in the next twelve months (e.g., as a result of a pending audit!). Even though the IRS has declared that it will not seek FIN 48 work papers (the notes showing the analysis and support for the FIN 48 accounting) unless the taxpayer engaged in a "listed transaction" (discussed below), companies fear that their financial statements will now create a quantitative and qualitative "roadmap' for taxing authorities.

FIN 48 work papers are now being sought by potential buyers of a business as part of their due diligence.

THE TAX INSURANCE SOLUTION

While tax insurance may not impact FIN 48 reserves, tax insurance promises cash for one or more uncertain tax positions. Thus, tax insurance may solve liquidity needs, may offset purchase price negotiation leverage, may render a technical default in loan or lease covenants caused by tax reserves to be immaterial and may, in the opinion of the company and its auditor, reduce the need for qualitative disclosure of tax issues because the insurance renders the matter immaterial.

For going-forward transactions, tax insurance offers a degree of certainty even beyond that which may be available through a private letter ruling, since tax insurance may cover some of the factual predicates for the tax position.

THE TAX INSURANCE POLICY

The Insuring Agreement

Generally, the Insuring Agreement will be a promise to pay Loss in excess of the Retention for a Claim made and reported during the Policy Period.

The key variables relate to "Loss" and "Claim." Generally, "Loss" will include additional taxes, interest and penalties assessed as a result of an adverse determination regarding the insured tax position. "Loss" may or may not occur with respect to a single tax year only (e.g., the tax position does not relate to recurring deductions or credits – ignoring carryovers and carry backs). If multiple years are subject to loss, a calculation of the probability of using future deductions and credits, any offsetting recapture and a proper discount rate may need to be considered.

Loss may also include a "gross-up", which is the taxes payable, if any, based upon the receipt of the insurance proceeds. There are arguments that a tax indemnity payment is not income and/or that it constitutes a reduction in basis (if the indemnity was given in connection with an acquisition). Taxpayers have generally cited Clark (40 BTA 33 (1939), nonacq., 1939-2 CB 45 (withdrawn), acq. 1957-2 CB 4) for the proposition that tax indemnity payments are excludible from gross income. Notwithstanding Clark, the IRS generally considers tax indemnity payments to be fully taxable. See, e.g., IRS Letter Rulings 9833007, 9743035, 9743034, 9728052 and 9226033; see also Old Colony Trust Co., 279 US 716 (1929).

Loss may also include defense costs, which can accrue either upon commencement of the audit or upon commencement of a lawsuit.

Loss may require adjustments for expected tax benefits associated with the loss. For example, if the policy insures an expense deduction and the ultimate outcome is that the expense must be capitalized, a fairly straightforward adjustment may be made since the only "loss" relates to the timing of the deduction.

The term "Claim" has two distinct aspects to be carefully considered. First, when is the insured required to report an audit of a tax return to the insurer? Second, what tax positions are, in fact, covered?

Generally, the audit should be reported as a claim when it first appears that the auditor is examining an insured tax position. For example, an Information & Document Request may be issued that expressly refers to the transaction that gave rise to the insured tax position – creating a "Claim." On the other hand, the mere examination of a return ought not to be a "Claim" prior to a focus on the insured tax position so that the insured can exercise its unfettered discretion in the way it responds to the audit.

The scope of the insured tax positions is crucial to all involved. While it will ultimately be defined in the Policy, clarity should be sought early in the submission process – so a broker and its client can potentially reduce costs and time and can compare quotes from numerous carriers as "apples to apples."

For example, an insured tax position could be as broad as: "The 338(h) (10) Election is valid." It can be narrowed to read: "The 338(h) (10) Election is not invalid as a result of the invalidity of the S corporation status on the part of the Seller." It could be further narrowed to read: "The 338(h) (10) Election is not invalid as a result of the invalidity of the S corporation status on the part of the Seller as a result of the Seller being deemed to have two classes of stock caused by the transactions contemplated in the Agreement."

Most underwriters will work collaboratively with the broker and its client to achieve a refinement of the risk early in the submission process.

Conditions, Exclusions & Other Provisions

The Policy Period is typically co-extensive with the statute of limitations.

What if the insured desires to consent to extend the statute of limitations? Generally, the consent should be granted only with the consent of the Insurer, which won't be unreasonably withheld or delayed. The impact of granting such consent should be either a claim is deemed to have been reported (so the ending of the policy period will not impact the coverage) or the policy period is extended until the closing of such tax year.

A well drafted insurance agreement generally need not contain many policy exclusions.

Generally, fraud on the part of the insured is excluded. Loss related to a material inaccuracy in the summary of the insured tax position provided to the insurer (unless through no fault of the insured) is generally excluded. If the insured fails to file returns consistent with the insured tax position, loss may be excluded. If the insured matter encompasses a "preference item" for purposes of the alternative minimum tax, the AMT is typically excluded. Most importantly from an industry perspective, "reportable transactions" (discussed below) are excluded.

How the insurer will participate in an audit, once a claim is reported, is often an area of keen interest for the insured. The insured has to "live with" the revenue agent for all of its tax positions on all of its returns being audited. The insurer, on the other hand, fears a "set up" by trading on non-insured issues for settlement of insured tax positions. One solution is to have the insured appoint, at the insurer's expense, an additional attorney named by the insurer, on its power of attorney form filed with the taxing authority. The additional attorney can hear and read

everything, but can only speak or write to the taxing authority with the consent of the insured.

THE MARKETING OF TAX INSURANCE

Tax insurance requires marketing to tax advisors (indirect marketing) as well as to tax directors (or similar officers) of taxpayers and other tax reporting entities (e.g., partnerships) (direct marketing).

An excellent example of indirect marketing is meeting with one or more members of a law firm's "Opinion Committee" and persuading them to include the following provision (or similar wording) in all of their tax opinions:

> "The tax opinions expressed herein should not be taken as a guaranty of the ultimate tax treatment. If further assurance is sought on the matters opined upon herein and/or on the assumptions relied upon herein, we recommend that you consult with an insurance company or broker that can provide or procure tax insurance for these matters. We would be happy to assist you in that effort, if you so desire."

One approach to direct marketing is for a broker to review its clients' financial statements to determine if reserves have been charged for uncertain tax positions.

Another useful marketing tool is provided by the IRS. Each year, the IRS issues a statement about the types of matters for which a private letter ruling or advance determination is not available. Rev. Proc. 2008-3 provides this year's listing. Because a taxpayer cannot obtain a private letter ruling or advance determination on an issue listed in Rev. Proc. 2008-3, a taxpayer cannot obtain certainty around the issue – unless it obtains tax insurance.

Tax issues arising from extraordinary corporate transactions and reorganizations for which no private letter ruling is available are probably the most likely candidates for tax insurance.

Lastly, tax due diligence is generally performed in connection with an extraordinary transaction. Tax insurance may be a solution to any disclosed or discovered uncertainty.

THE SUBMISSION & UNDERWRITING PROCESS

Some (if not most or all) tax insurance underwriters do not require a tax opinion. If a tax opinion, however, has been obtained, or if a memorandum has been prepared addressing the tax issues sought to be insured, it should be forwarded as part of the submission.

The underwriter should immediately confirm that the tax position is not a "reportable transaction" (discussed below) and that it otherwise is within its "risk appetite." The "refinement of the risk" process generally should be undertaken collaboratively with the broker, its client and the underwriter, perhaps with some additional supporting materials being requested and forwarded in that process that will aid the underwriter in providing a preliminary assessment of the risk.

A complex risk (particularly if it is factually oriented around multiple transactions or events taking place over a lengthy period of time) may necessitate a "quote" or indication of interest being issued with a range of financial terms, the finalization of which will happen as the underwriting progresses. This allows the parties to engage in a "reality check" before too much time and expense is incurred by all sides.

REPORTABLE TRANSACTIONS

Underwriters should not insure and brokers should not place insurance for reportable transactions. The U.S. Treasury and the IRS deem underwriters and brokers who do bind/place insurance for reportable transactions (and receive a threshold amount of compensation for such) to be "material advisors" and impose filing and record-keeping requirements on them with respect to such insurance. The failure to comply with the "material advisor" regulations can result in stiff penalties – up $200,000 if the material advisor is an entity and the underlying matter was a listed transaction. A material advisor who fails to produce a list required to be kept by it within 20 days of written request by the IRS is subject to a penalty of $10,000 per day!

There are currently six categories of reportable transactions:

1) Listed Transactions.
2) Confidential Transactions.
3) Transactions with Contractual Protection.
4) Loss Transactions.
5) Transactions Involving a Brief Asset Holding Period.
6) Transactions of Interest.

A more detailed description of these transactions can be found in the article posted on the PLUS website.

THE PROSPECTS FOR TAX INSURANCE

Tax planning is still permissible. Tax evasion never was. Tax insurance serves to safeguard tax planning in light of the inherent complexity and uncertainty of our tax code.

Today, the certainty and liquidity offered by tax insurance is needed more than ever as a result of the new accounting rules known as FIN 48 and an economic climate that demands greater certainty of risk.

Tax insurance brokers and underwriters are positioned for strong growth in this niche market if they can successfully identify and execute the transfer of sophisticated tax risk in a timely manner, upon agreeable terms, while avoiding the potential pitfalls of "reportable transactions."

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