Howden Tax & Contingent Risk

Infrastructure Investments

How Tax Insurance can help with certainty regarding tax assets

Infrastructure Investments – Protecting tax assets

Infrastructure Investments

The need for capital to develop long term sustainable infrastructure is larger than ever and fund managers are responding to this. With approximately 75% of the world's infrastructure in 2050 yet to be built, the global infrastructure sector holds significant potential for growth.

Tax Assets - Position in W&I Policies

Howden has been assisting investors on placing warranty and indemnity ("W&I") insurance policies on M&A activity in this space and a key item which comes up often is the request to provide insurance cover for the risk of tax assets at closing not being available to offset future taxable income.

W&I policies have a standard exclusion for "loss of tax assets" and this is often difficult to remove from the W&I policy even when due diligence is performed on these tax assets and value is also being attributed to these tax assets (for e.g. tax losses) on the purchase of shares in a Target Group. This is because:

(i) The amount of potential loss that could crystallise as a result of the tax assets not being available post-completion forms a material part of the policy limit being taken out (c. 30% or more); or

(ii) The position of the tax assets surviving post-completion due to certain change in ownership/activity rules not being that clear.

How tax risk insurance policies can help

Insurers have a higher risk appetite to cover loss of tax assets under specific tax risk insurance policies than under W&I policies. The tax risk insurance market can provide cover in the event:

(i) The tax assets are not available post-closing due to the tax assets being forfeited due to change in ownership/activity rules; and/or

(ii) The quantum of tax assets being incorrect at closing and the quantum being challenged by a tax authority post-closing.

Insurers will require diligence to be performed on why the tax assets should survive post-closing and why the quantum of tax assets is correct.

Typically under tax risk insurance policies, the "Loss" is the additional amount of tax (plus interest and penalties) payable to a tax authority and requires the tax authority to issue a demand for the additional tax due.

However, under such policies, the loss mechanism is amended to be such that if the tax assets are forfeited or an audit results in some of the quantum of tax assets being reduced, there is a pay-out under the policy for the loss in value of the shares (which is determined by how an investor was factoring the tax assets into the purchase price of the shares).

This is a much better position for insureds rather than having to wait and claim for any additional tax payable each year as a result of certain tax assets not being available.

How tax risk insurance policies can help (Cont)

A few examples where we have covered these risks are:

(i) Coverage for tax losses surviving post-closing of a company in the oil and gas sector in the UK. The buyer intended to carry out certain restructuring post-closing to merge the acquired business with its existing business and there was a risk that the major change in the nature or conduct of a trade ("MCINOCOT") rules could come into pay such that the tax losses would be forfeited.

(ii) A Portuguese target company had material amounts of tax losses that a buyer was taking into account when valuing the business. Although due diligence was done on historical tax returns to verify the amount of tax losses, there was ambiguity about the deductibility of certain material expenses over the years. If those deductions were challenged, the amount of tax losses would reduce significantly. A tax risk insurance policy was placed to cover the quantum of the tax losses at closing