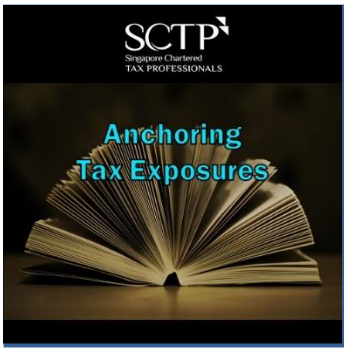

Managing Tax Exposures

Protect Against Unexpected Tax Liabilities
And Secure Certainty

14 January 2022, Friday

Facilitated by:
Mr Vijay Nair

Against the backdrop of changing tax legislations and regulatory requirements, evolving business models and rapidly advancing technology, companies have to grapple with how tax rules apply to their business operations and adopt tax positions based on their judgements.

Given that judgements are involved, it is safe to say that the tax authorities will not always agree with taxpayers' interpretation of the tax rules and the tax positions they adopt. Such disagreements will result in uncertainties over multiple financial years and, in some cases, lead to significant tax exposures.

"Tax risks, if not managed properly, can lead to severe financial exposure and even reputational risks for a company," highlighted Vijay Nair, Associate Director, Tax and Transaction Liability, Aon, at a webinar organised by the Singapore Chartered Tax Professionals. "Tax insurance is a useful tool to help companies manage their tax risks. Companies should keep this in mind when reviewing their overall tax risk management strategy."

What is Tax Insurance?

Tax insurance is essentially a risk management tool where a company pays a premium to transfer an identified tax risk to an insurer. As the insurer takes on the tax risk (and becomes liable for any taxes which may arise from a successful challenge by the tax authority), the company has effectively eliminated its exposure to the identified tax risk.

Unlike a warranty and indemnity insurance policy which covers the insured party for any unknown risks at the time of entering into a transaction, a tax insurance policy only covers identified tax risks.

In practice, a warranty and indemnity insurance often excludes issues such as transfer pricing, secondary tax liability, as well as other issues identified in a tax due diligence. However, such issues may be covered under a tax insurance. Tax insurance may also be used to cover other known tax risks, such as the taxability of certain gains, the deductibility of certain expenses, withholding tax rates applied or tax risks arising from restructuring transactions.

Coverage

In a tax insurance policy, the insured is typically covered against losses arising from the failure to achieve the expected tax treatment. These may include the tax liabilities plus any interests and penalties, the defence costs incurred to defend the tax authority's challenges, and the tax gross-ups on the proceeds of the insurance.

The duration of a tax insurance coverage is typically linked to the statutory limitation period of the relevant jurisdiction (generally five to seven years).

Features

It is important to note that the insurer will only pay out claims relating to losses incurred on the specific tax risk(s) as defined in the tax insurance policy. Tax risks that are not specifically covered in the tax insurance policy will be excluded.

Common exclusions of tax insurance policies include fraud, material misrepresentation, and a change in law. For example, if Singapore changes its law to tax capital gains and a tax policy was put in place prior to the disposal, the insurer will not pay out claims relating to any losses arising from the change of law (notwithstanding that the insured may have robust analysis and documentations to support that the gains are capital in nature and would not have been taxable under the old law).

Pricing

The premium for a tax insurance policy is typically a percentage of the sum insured and paid as a one-off payment upfront. Pricing is specific to the identified tax risk and may also be adjusted depending on market conditions, jurisdiction(s) covered and the size of the risk.

What Kind of Tax Risks Are Insurable?

In general, a tax risk may be insurable if:

- There is a low probability of it happening but its potential impact on the business is high (generally, for tax exposure of at least $1 million);
- It results from a historic or proposed transaction where the law is not completely black and white;
- It is not an aggressive tax avoidance arrangement or contrived structure;
- There is a sound legal basis for the tax position taken.

On the other hand, if a tax risk does not qualify as a remote or low risk (such that there is a medium or high possibility of it happening), it will generally not be insurable. For example, the insurance market is unlikely to take on the risk of covering a tax position on the deductibility of a certain expense if the position is not strong and is expected to be challenged by the tax authority and argued in the courts for a prolonged period.

While the insured is responsible in defending its tax position from a challenge by the tax authority, the insurer is expected to be kept informed. In some cases, the insurer may also participate in the defence of the tax position.

Common tax risks insured extend beyond merger and acquisition (M&A)-related risks, and may include risk areas such as permanent establishment, tax residency, withholding tax, availability of treaty benefits, indirect share transfer, transfer pricing on certain related parties' transactions, interest deductibility, and characterisation of revenue versus capital receipts.

Strategic Uses of Tax Insurance

Tax insurance may be used for a myriad of strategic reasons:

1. Attain peace of mind through tax certainty

With a tax insurance policy in place, tax risks arising from the contentious issue are passed on to the insurer, and certainty to a particular tax outcome is achieved.

In an M&A transaction, tax insurance can provide cover on the small probability of significant loss and provide peace of mind for the parties involved. For example, a buyer may reduce its tax exposure by taking up a tax insurance policy to cover an identified tax risk for which the seller is unwilling to provide indemnity. With this, the buyer can factor in the cost of the insurance policy into its bid price and avoid uncertainties.

2. Avoid the need for advance ruling

The process to obtain a binding advance tax ruling from the tax authority may be protracted in certain jurisdictions, ranging from a few months to a few years. In this regard, advance tax rulings may not be the answer for transactions that are time sensitive. In situations where advance tax rulings are not feasible, a tax insurance may serve as an alternative to provide a faster option to achieve economic certainty and minimise exposures.

3. Replace or reduce escrow

In an M&A transaction, the seller may put in place a tax insurance policy to cover identified tax risks that it takes on. Accordingly, the seller may replace or reduce the escrow and free up cash without worrying about whether the tax position is challenged.

4. Unlock capital

Tax insurance eliminates the need to set aside monies in the event the tax risks materialise. Accordingly, it allows sales proceeds of a transaction to be fully distributed to shareholders, thereby maximising sales proceeds and unlocking capital in a cost-effective manner and help to achieve a "clean exit" from the M&A transaction.

5. Remove deal blockers

Tax insurance can help remove deal blockers, uncertainties and valuation issues in an M&A process. With a tax insurance policy in place, the seller may be able to offer broader representations and greater indemnity coverage, both in terms of scope and duration, as any claims will be made against the policy. This could improve the attractiveness of the target and optimise its valuation.

6. Eliminate balance sheet contingencies

With tax insurance providing protection to uncertain tax positions, balance sheet contingencies on such tax items can be eliminated.

Case Studies of How Tax Insurance May Be Used

NON-RESIDENT CAPITAL GAINS TAX

The seller, a private equity fund, is looking to sell its shares in a Korean target.

Based on Korean tax rules, the buyer is required to withhold Korean capital gains tax. As there are risks relating to the availability of tax treaty relief for the investors in the private equity fund, the buyer requires an indemnity and escrow from the seller. Under the escrow, the seller's funds will be tied up for 10 years, and this will in turn affect the internal rate of return of the private equity fund and prevent the closing of the fund.

The private equity fund may consider putting in place a tax insurance policy to protect the buyer against the tax risks, and negotiate the release of the escrow since it is no longer required.

TRANSFER PRICING

A Singapore-headquartered company carries out a distribution business in Asia. Based on robust transfer pricing analysis and documentation prepared by its tax advisor, the company's related entities across Asia are characterised as "limited risk distributors" and remunerated on a cost-plus basis.

Even though the company's transfer pricing positions were supported with robust analysis and documentation, there is still a small risk that the local tax authorities may challenge the company's transfer pricing arrangement. The company may consider tax insurance to cover the identified transfer pricing risk if the financial exposure is significant.

As the global tax landscape becomes more complex and the scrutiny by tax authorities intensifies, tax insurance can be a very useful tool for companies and tax professionals in managing tax risks and minimise tax exposures. In certain circumstances, it may even be the only feasible tool.

Please click here to rate this article.

Facilitator

Mr Vijay Nair
Associate Director, Tax
Transaction Liability Insurance
Aon Singapore
E: vijay.v.nair@aon.com

Felix Wong is Head of Tax, and Angelina Tan is Technical Specialist, Singapore Chartered Tax Professionals.

For more tax insights, please visit www.sctp.org.sg