MARSH

TRANSACTIONAL RISK PRACTICE

Tax Insurance: Enhancing Certainty During Times of Distress

The ongoing COVID-19 pandemic has dealt a severe blow to the US and global economies, and will likely leave many companies in financial distress. When responding to such situations, companies may consider restructuring, raising new debt, modifying existing debt, seeking to access capital, and/or divesting assets. For distressed companies and for buyers of distressed assets and businesses, tax insurance can serve as a critical risk mitigation tool.

Marsh specialists understand the risks that financially distressed companies can face, and can deliver a unified suite of services to aid them, including guidance on tax insurance. Marsh specialists can help the financially distressed access tax insurance to gain certainty related to net operating losses (NOLs), tax credits, interest expense deductions, and other debt-equity tax issues.

Certainty and Credit Enhancement

Tax insurance provides two key benefits to companies in distress:

- Certainty: Tax insurance can provide a backstop to — or replacement for — a seller tax indemnity and can mitigate balance sheet tax risk.
- Credit enhancement: A diversified pool of highly rated insurers can provide coverage to supplement a borrower’s tax indemnity or creditworthiness.

In private equity transactions, tax insurance can help a buyer mitigate historic risks when acquiring a company that may have tax issues related to debt and tax attributes. Sellers can also use tax insurance as a way to eliminate escrow arrangements and reduce indemnity obligations. For transactions involving multinational companies, tax insurance can be used to reduce “on balance sheet” tax risks in preparation for future sales of assets or equity or to potentially reduce accounting reserves.

MARSH & McLENNAN COMPANIES

Common Areas of Coverage

Bespoke tax insurance policies can be crafted to address one or more identified tax positions, including the following.

Modification of Debt Instruments

Modification of a debt instrument can trigger unforeseen tax consequences. Specifically, it can result in a deemed taxable exchange of an old debt instrument for a new one and cause a debtor to recognize cancellation of debt income. Common areas of coverage related to modification of debt instruments include:

- A gain recognition event under Section 1001 of the Internal Revenue Code.
- Deemed satisfaction and reissuance (debt for debt exchange).
- Cancellation of indebtedness (COD) income to a borrower.

Investor Considerations

In private securities markets, an investment fund's lending activities — particularly to distressed companies, may give rise to unanticipated tax consequences. For example, investment funds engaged in these lending activities are generally organized outside of the US in order to minimize US income tax. Foreign funds must implement careful tax planning strategies to avoid such tax on their profits. Tax insurance can help mitigate risk and ease tax planning concerns regarding effectively connected income and seasoning periods.

Net Operating Losses (NOLs)

One of the principal tax goals of a troubled company and its creditors is preserving the company's NOLs and other tax attributes. Tax insurance can provide certainty around:

- The impact of the Coronavirus Aid, Relief, and Economic Security (CARES) Act on NOL carryback and carry forward rules.
- The impact of loss limitation rules under Section 382.
- Valuation issues.

Of particular interest for companies seeking to raise capital today is that the CARES Act has restored "carryback" rules, which apply to tax years 2018, 2019, and 2020. Accordingly, taxpayers may be eligible to seek substantial income tax refunds of prior taxes paid.

The CARES Act also removes the 80% limitation on taxable income and allows for access to previously paid taxes at higher tax rates (35%), which should enable greater access to capital. Timing for this refund can vary, so it's important for distressed companies to consult with their tax advisors on the fastest way to access refunds.

Restructuring

Tax insurance provides certainty to an insured's tax position related to restructuring projects. Examples of tax insurance solutions for restructuring projects include:

- Section 382(l)(5) "old and cold" creditor exceptions for companies in Chapter 11 bankruptcy.
- Section 382 "change of control" issues.
- Worthless stock and bad debt deductions.
- The acquisition of related party debt.
- Section 368(a)(1)(G) insolvency reorganizations.
- Section 355 spinoffs.
- Section 280G golden parachute rules.

Other CARES Act Issues

The CARES Act provides taxpayers with several benefits that can be maximized through careful tax planning strategies. Tax insurance is an effective risk management tool to provide certainty around such planning strategies, including issues related to:

- Employee retention credits.
- Excess business loss limitation deferrals.
- AMT credit refund considerations.
- Section 163(j) earnings stripping relief (changing from 30% to 50%).

State Tax Issues

Tax insurance can also provide solutions for state and local tax issues. For example, tax insurance may provide solutions with respect to uncertainty around nexus and apportionment positions due to teleworkers in states where a company lacked physical presence prior to COVID-19 or ensuring tax credit/incentive agreements where compliance with the agreement may be uncertain due to business disruptions as a result of COVID-19.

Setting the Right Limit

A tax insurance policy typically covers:

- The value of lost tax attributes (liability for additional taxes).
- Penalties and interest levied by taxing authorities.
- Defense costs related to the tax authority challenge (in excess of the policy's retention).
- A gross-up where the receipt of payment under the policy is taxable.

The quantification of additional taxes requires balancing the need to secure appropriate protection against the desire to not overinsure, taking into account the objectives of the tax insurance policy.

Why Marsh?

With experience helping companies in distress and backgrounds in taxation, corporate law, investment banking, and accounting policy, the specialists in Marsh's Global Transactional Risk practice are well-positioned to help distressed companies build effective tax insurance programs.

We understand the critical risks you can face during and after a transaction, including while in distress. We have relationships with all leading transactional risk insurers, enabling us to deliver robust, competitively priced, and cost-effect solutions via an efficient process — typically three weeks from initial discussions to the binding of a policy. Working with our international team, we can coordinate coverage globally, and help you strike the right balance between securing appropriate protection while not being over-insured. And we can help you navigate all aspects of the transactional risk claims process.

CHAPTER 11 — OWNERSHIP CHANGE

Company A loans money to Company B, which files for bankruptcy under Chapter 11. As a result, Company A's debt is swapped for an equity share in Company B; Company A inherits significant NOL carryforwards. Section 382 rules are complex and the facts and circumstances surrounding the restructuring give rise to risks that affect its ability to preserve tax attributes.

Solution: Marsh can help Company A secure a tax insurance policy covering the position that NOLs would not be limited under Section 382 ownership change rules due to the debt for equity exchange and bankruptcy proceedings. This can provide Company A with certainty that it will receive the full anticipated value of NOL carryforwards in the event of a successful tax authority challenge.

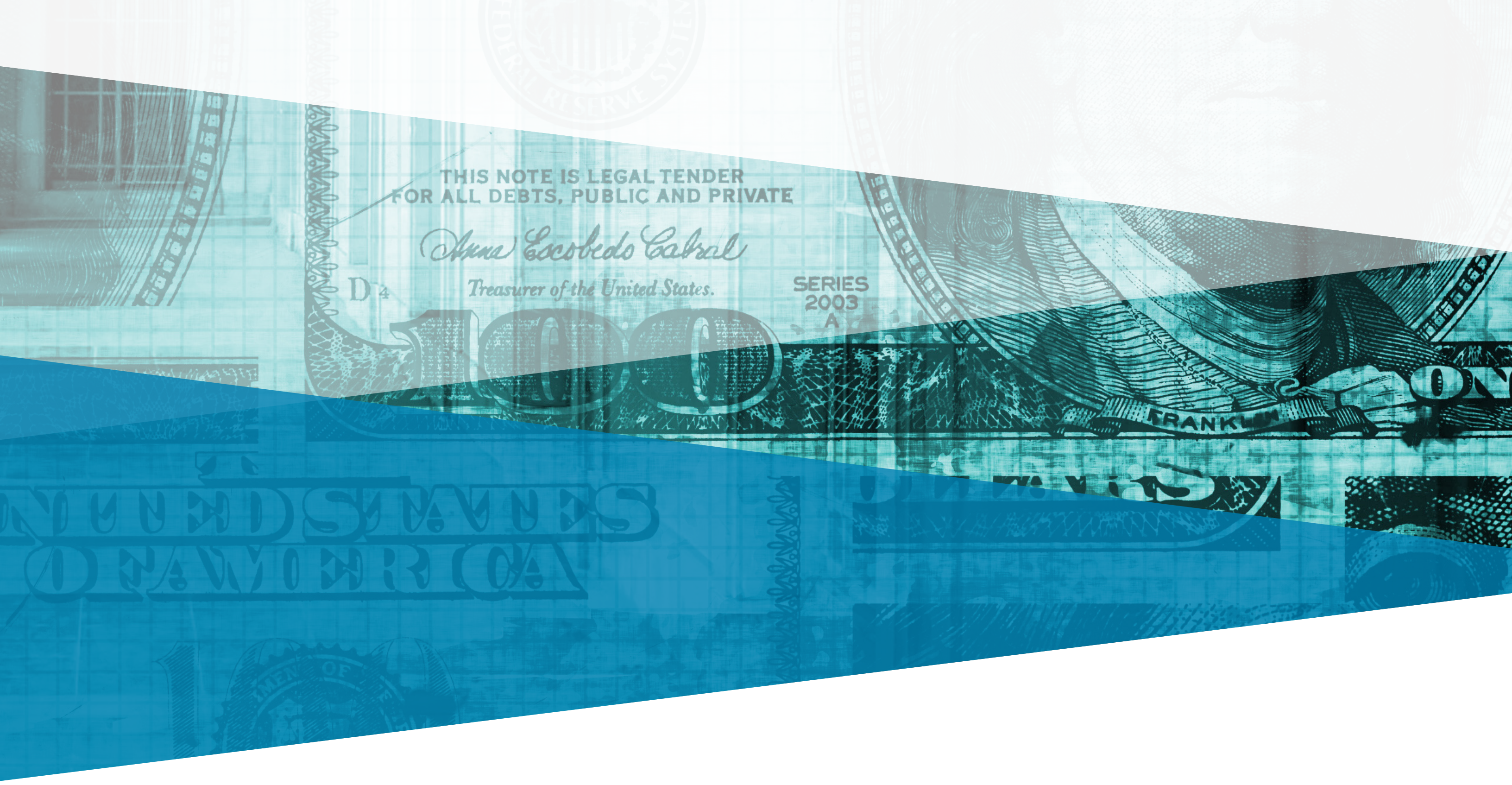
CHAPTER 11 — BAD DEBT DEDUCTION

ABC Company enters into an intercompany agreement to make loans to a subsidiary. ABC and its subsidiaries subsequently file for Chapter 11 bankruptcy. ABC claims a bad debt deduction on its federal income tax return for the year of bankruptcy.

Solution: Marsh can help ABC secure a tax insurance policy covering its positions that:

- The loans (in the form of notes) constituted debt at issuance until it became worthless.
- The bad debt deduction should be allowed for the year of the bankruptcy filing.

This can protect ABC's position against a successful IRS challenge.



For more information, contact your Marsh representative or:

ANTONY JOYCE
Senior Vice President —
Tax Insurance Specialist
+1 212 345 0780
antony.joyce@marsh.com

MARK MCTIGUE
Senior Vice President—
Tax Insurance Specialist
+1 212 345 5635
mark.mctigue@marsh.com

ALISHA SOARES
Senior Vice President —
Tax Insurance Specialist
+1 212 345 3121
alisha.soares@marsh.com