



Transactional Risk Insurance
FAQ - FREQUENTLY ASKED QUESTIONS
Tax Insurance

1. What is an example of a successful placement?

Tax-Free Spin-Off of Subsidiary

- *Situation:* Company A effectuated a tax-free spin off to its shareholders of Subsidiary X for the purpose of allowing Subsidiary X to effectively raise capital. About one year later, Company A received an unsolicited, unexpected offer to be purchased at a significant premium to its widely accepted value. If Company A accepts the offer, the IRS could challenge the spin-off as part of an arrangement by which Company A sold itself, which would jeopardize the tax-free status of the spin-off.
- *The Hartford Solution:* As part of the acquisition of Company A, The Hartford issued a Tax Insurance policy insuring Company A (and/or its successor) from tax liability (plus interest and gross-up) resulting from the spin-off being stripped of its tax-free status.

2. What are the key policy provisions that distinguish markets?

Although the policies are often manuscripted to accommodate the particular concerns associated with a specific transaction, certain “standard” provisions may be compared and contrasted.

- (a) Is the “Tax Loss” appropriately defined?
- (b) What constitutes a Claim (e.g., audit – in which case defense fees are reimbursed as of the earliest period; or 90 day letter, etc.)?
- (c) Will the Insurer allow for a cash-bond and/or for a payment coupled with a request for refund (to allow prosecution in the U.S. District Court or Court of Claims)?
- (d) What level of participation in an examination or litigation does the Insurer require?
- (e) Does the Insurer require an opinion (and, if so, what level of certainty is required)?

3. What is the typical price and structure for Tax Insurance?

The most preferred structure is that the taxpayer share some of the risk either through (i) a retention, (ii) a coinsurance provision or (iii) reduced limits.

The Retention is a function of the following factors:

- (1) likelihood of audit;
- (2) magnitude of exposure;
- (3) probable cost of defense; and

(4) probable settlement range.

A Retention adequate to cover the probable cost of defense and probable settlement range will likely result in a premium that is at the lower end of the premium range, which is, in general, approximately 7 – 11% of the limits of liability. A lower retention may be offered generally for additional premium.

An underwriting fee is generally charged as part of the acceptance of the quote and/or at time of binding. The underwriting fee is generally approximately ten percent of the rate on line.

4. What is the typical underwriting process for Tax Insurance?

The initial submission should be screened against the following criteria:

- Is it a “tax shelter”? Generally, if an investment vehicle was registered as a tax shelter, we are not interested in insuring its expected tax consequences. If the transaction did not require registration, but lacks business purpose and/or economic substance (e.g., the deal would only be done to secure tax benefits derived from a manipulation of the tax code), we would be disinclined to insure its expected tax consequences.
- Is the tax position predominantly a matter of valuation or other subjective criteria? If it appears that the “factual” underpinnings are suspect, we would be disinclined to insure the matter absent a significant retention.
- Can the “loss” be quantified? For example, the expected tax consequences of a step-up in basis in assets may be realized, if at all, only over the expected life and use of the assets. A reasonable analysis of the depreciation and amortization schedules, coupled with reasonable assumptions about the sale or abandonment of the assets, and the future net income of the company, are all factors in determining the present value of the expected tax consequences to a transaction resulting in a step-up in basis.

The initial submission should contain:

1. A detailed description of the transaction;
2. A detailed description (or opinion) of the tax position;
3. The identity of the insured;
4. A description of the insured’s audit history with the IRS; and
5. A loss calculation.

The Hartford will either decline to insure (by telephone and letter) or will provide a letter of preliminary interest (the “Quote Letter”). The Quote Letter will likely set forth a range of amounts of respective premium, limits and retention and may request an underwriting fee in order to finalize the underwriting.

Contacts

For general information or forms:

Jacqueline Pierangelo, Administrative Assistant – (212) 277-0724; or

David M. Anderson, Esq., Vice President – (212) 277-0488 (tax)

Kenneth W. De Berry, CPA, First Vice President – (212) 277-0441 (reps)

Martin J. Conroy, Esq., Vice President – (212) 277-0449 (specific litigation)

David S. De Berry, Esq., First Vice President - (212) 277-0489 (managerial)