MARSH JLT SPECIALTY

COVID-19: Implications for Tax Insurance and Corporate Restructuring

Since the outbreak of COVID-19, mergers and acquisitions activity has reduced significantly and many businesses have shown signs of financial distress.

As and when the pandemic's immediate risks recede, many large companies experiencing a downturn in revenues will need to undertake corporate and debt restructuring. This will ensure their business remains sustainable and positioned for growth. Summarised below are some of the risks to consider during a corporate and debt restructuring, and how tax insurance may help.

Debt Restructuring

Debt restructuring is used by companies to avoid the risk of default on existing debt, or to benefit from lower available interest rates. **It may be achieved by:**

- Reducing interest rates on loans or by extending the dates when a company's liabilities are due.
- A debt-for-equity swap, where creditors agree to cancel a portion of or all the outstanding debt in exchange for equity in the company.
- Write-down of debts.

A number of tax issues can arise during debt restructuring. For example, if loans are between connected parties, transfer-pricing concerns may arise in relation to changes to interest rates. Alternatively, the write-down or conversion of debts could equally give rise to tax consequences. Despite the intention to achieve debt restructuring in a tax-neutral manner, uncertainties may remain over whether the tax authority could challenge the position taken.

In many cases, it should be possible to insure tax risks relating to debt restructuring. For example, Marsh JLT Specialty recently arranged a tax insurance policy, insuring the risk that a debt restructuring may be taxable, or alternatively reduce tax losses going forward. An insurer generally cannot require that any existing corporate tax losses first be offset against its insurance pay-out, which means that in effect losses are protected going forward to be offset against future profits, should the risk materialise.

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Corporate Restructuring

Distressed corporate groups often enter into corporate restructurings in order to wind up unprofitable operations, reduce overall costs, and take advantage of synergies/ overlaps. Whether the restructuring entails the transfer, merger, or liquidation of group companies, there are usually tax risks, which can be mitigated.

In this regard, tax insurance is often helpful in the following scenarios:

1. Tax insurance in lieu of tax clearances

Sometimes the tax law and/or its application to a particular set of steps in a restructuring plan may be uncertain. In such cases, it is often recommended that a tax ruling is obtained from the relevant tax authorities in order to confirm the tax position.

However, obtaining a tax ruling can take an extended period of time, which is often not practical and creates time pressures. In addition, the outcome of a tax ruling application may not be certain. In contrast, insuring the tax risk is relatively quick, and the coverage of the tax insurance policy can be managed.

2. Insuring valuation risks

A certain tax treatment may depend on a particular valuation of a company or underlying assets. In this case there is usually no uncertainty relating to the interpretation of the tax law, but an incorrect valuation may result in additional tax charges.

Tax insurance makes it possible to insure the valuation risk, that is, the correctness of a certain valuation, in a tax context.

3. Implementation of restructuring steps

The tax consequences of a particular restructuring plan are often subject to proper implementation.

Insurers should be willing to review the underlying (draft) implementation documents and confirm the expected tax treatment with insurance cover, based on the implementation documents. However, an insurer is unlikely to insure that the steps would be properly implemented in future in the absence of any implementation documents to review.

4. Blanket tax insurance cover for restructuring

Tax advisors may be of the view that there should not be any tax exposures attached to a particular restructuring plan they have developed. The question then arises whether a tax restructuring plan can be insured as a whole in order to provide cover for any “unknown” tax risks arising as a result of restructuring.

In principle, it should be possible. For such insurance to have value, it is recommended that the insurer also reviews and warrants the underlying (draft) implementation documents, in order to confirm the view there should not be any tax risks attached to the restructuring.

Conclusion

As economies recover from COVID-19’s impact, businesses, private equity firms, and strategic investors will inevitably seek to restructure to protect their investments. Tax insurance can support the process and provide protection against unexpected changes in tax treatment, reducing uncertainty while providing fiscal certainty when it is most needed.

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