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Tax Insurance

Case studies

Potential tax exposure of borrower prevents lender from extending credit

The credit committee of a lender has approved all aspects of a loan to a company but has reserved final signoff until it is satisfied that the crystallization of a potential tax exposure will not impair the company's ability to repay the loan. The potential tax exposure relates to the tax-free spinoff by the company of its office supply business. While the company has received a tax opinion from a reputable law firm that the spinoff should be taxfree, the analysis is a facts and circumstances analysis. As such, the lender is concerned that the IRS will unexpectedly contend that the business of the spunoff entity and the remaining business of the company should have simply been operated as two separate subsidiaries, and may determine that there is insufficient business purpose to support the taxfree spin-off. As a solution, an *InterpretationGap®* policy may be obtained by the company, with the lender as a "loss payee," in the event the tax authority challenges the taxfree nature of the spinoff and the company cannot repay the loan.

Potential tax exposure at company prevents investor from making an investment

A potential investor in a distressed company has identified the reclassification of a large number of independent contractors retained by the company as employees as a risk factor. While the company has several legal opinions concluding that its independent contractors are properly classified pursuant to the guidance given by tax authorities on the subject as well as case law, given the political climate, there remains a risk that an attempt will be made to reclassify the independent contractors as employees. The company will not be able to withstand the financial impact of such a re-characterization. As a condition to the investment in the company, an *InterpretationGap®* policy may be obtained by the company to respond in the event the tax authority challenges the classification of the company's independent contractors.

Potential challenge to transfer pricing

All intellectual property of a business is held in the subsidiary of the target company in an acquisition. The effective tax rate in the jurisdiction in which the subsidiary is domiciled is lower than that of the jurisdiction in which manufacturing subsidiaries that license much of the target company's intellectual property. Despite the fact that the target company has demonstrated a significant business purpose for the location of the subsidiary holding the licenses, as well as significant documentation relating to the similar licensing agreements entered into by unrelated third parties that would show that the terms of the licensing agreements are arm's length, the buyer has concerns about the financial impact of a challenge by the relevant tax authority. In order to close the transaction, the seller may provide an indemnity to the buyer to respond in the event the tax authority challenges the tax treatment, and purchase an *InterpretationGap®* policy to protect itself from the tax exposure it has provided under the indemnity.

Required survival period of tax indemnity prevents liquidation of a fund

One of the largest shareholders of the target company in a proposed sale is a private equity fund. While the fund is willing to provide an indemnity for any exposure that is identified during the first 12 months after the transaction closes, the buyer requires an indemnity that survives for six years with respect to all preclosing tax liabilities. Providing an indemnity of this size will prevent the private equity fund from proceeding with its planned liquidation soon after the 12-month anniversary of the close of the proposed transaction. As a solution, the buyer may obtain an *InterpretationGap®* policy to respond to any preclosing tax liabilities of the target company.

Potential challenge to place-in-service date of equipment intended to qualify for bonus depreciation

The target company in a pending transaction started an assembly line in the middle of September 2001 and claimed bonus depreciation. The buyer was concerned that the assembly line may be found to have been "placed in service" prior to September 10, 2001. Such a determination would cause the seller to lose its ability to claim bonus depreciation, which in turn would mean that it significantly underpaid taxes in 2001. The seller is confident that it was entitled to claim bonus depreciation, and is unwilling to provide any security or holdback in the event it is determined that bonus depreciation was incorrectly claimed. An *InterpretationGap®* policy may be purchased by the buyer to respond in the event the tax authority challenges the assembly line's placed-in-service date, allowing the transaction to close.

Potential limitation on use of net operating loses

During the due diligence process for a pending acquisition of a target company which is the subsidiary of a large financially distressed company undergoing a restructuring, the potential buyer's tax advisor identifies a remote risk that net operating losses (NOLs) incurred by the company in years 2002 through 2006 could be limited as a result of a change in ownership. Tax advisors to both the proposed target company and the buyer agree that given the facts, the risk is low that the limitation on NOLs available to the target company following the transaction will be limited to a greater extent than if no change in ownership had occurred. However, due to the poor financial condition of the seller, a meaningful indemnification for the potential tax risk is not available. An *InterpretationGap®* policy may be purchased by the buyer to respond in the event the tax authority determines that the NOLs are limited as a result of a change in ownership, allowing the transaction to close.

Potential re-characterization of transaction treated as asset sale for tax purposes

The shareholders of an S Corporation target and the acquiring corporation agree to make a Section 338(h)(10) election whereby the stock sale is ignored for income tax purposes and treated as an asset sale instead. The buyer's tax advisors identified a risk that the target could fail to qualify as an S corporation as a result of certain circumstances which existed prior to the transaction (such as excessive salaries or perquisites to employee/shareholders or nonproportional dividends) that are deemed to have resulted in the issuance of a second class of stock. Tax advisors to both the target and buyer agree that given the facts, the risk of the Section 338(h)(10) election being successfully challenged is very low. However, neither the buyer nor the selling shareholders are willing to assume the risk. An *InterpretationGap®* policy may be purchased by the buyer to respond in the event the tax authority challenges the Section 338(h)(10) election, allowing the transaction to close.

Ambridge Partners LLC, 1140 Avenue of the Americas, 5th Floor, New York, NY 10036 T: 212.871.5400, W: www.ambridge-group.com