WARRANTY & INDEMNITY

MIND THE GAP

Oliver Walker and Erica Rees shine a light on tax exposures that fall outside the scope of traditional warranty and indemnity insurance policies

Warranty and indemnity (W&I) insurance has become relatively commonplace in the context of European corporate acquisitions.

Whereas parties to an acquisition (the buyer and seller) may previously have expected to fund any claims under the transaction documentation out of their own resources, the perception among investors now is that there is an established market of underwriters willing to cover the risk.

This is also true in the case of risks that, although identified during the acquisition process, fall outside the scope of traditional W&I insurance policies.

A seller in a relatively strong bargaining position may only provide limited protection under contractual warranties and indemnities, or may seek to mitigate its exposure through limitations (which might include a low financial cap on its total liability, or a short limitation period during which claims may be made).

Accordingly, buyers that feel inadequately protected are increasingly turning to W&I insurance in order to obtain additional comfort in parallel to agreeing the terms of the acquisition. In some cases, the seller will itself finance (whether wholly or partly) the buyer's premium.

Likewise, sellers that remain exposed under warranties and indemnities, after taking into account any contractual limitations, may seek insurance to guard against the risk of a claim by the buyer.

While the insured party and the underwriter will usually carefully consider the scope of W&I cover, the tax treatment of the insurance proceeds is often overlooked. Such an omission can be disastrous, particularly where the insured party is expecting full compensation for the underlying liability.

By way of example, where a seller insures against indemnity claims for up to EUR10mn of historic tax liabilities in the target business, any tax suffered on receipt of the proceeds would reduce the funds available to meet such claims (where the tax rate is 30 percent, it would need to find an additional EUR3mn in order to meet its contractual liability).

Tax on compensation

Depending upon the laws in the local jurisdiction, payments made by a seller to a buyer for breach of warranties or indemnities contained in acquisition documentation (e.g. a sale and purchase agreement, or SPA) are generally treated as a price adjustment.

Therefore, there is often no tax charge at the point that a payment is made by the seller to the buyer for a breach of warranty or indemnity claim – the seller pays the buyer x amount in respect of the claim, and a corresponding downward adjustment is made to the consideration which the seller received (and the buyer paid).

Notwithstanding this general expectation, SPAs often contain provisions that safeguard against either the seller's jurisdiction requiring the seller to withhold

tax from the payment, or the buyer's jurisdiction taxing the payment in the buyer's hands.

Accordingly, SPAs often provide that any payments made between the buyer and seller are (so far as possible) made by way of adjustment to the price, and require the paying party to pay an additional, "gross-up", amount such that the recipient is left with a sum equal to the amount it would have received absent any such taxes.

Tax on insurance proceeds

The receipt of insurance proceeds will usually require a separate analysis for tax purposes. As the payment will not be made between the buyer and seller, it may not be possible to treat it as an adjustment to the purchase price, and the gross-up provisions in the SPA will not assist.

The first step will be to determine whether the proceeds should be taxed as either income or capital of the recipient (usually, but not necessarily, the policyholder) either pursuant to general principles or to specific charging provisions in the relevant legislation.

The nature of the proceeds will help determine not only the applicable rate of tax, but also whether tax is chargeable at all.

Under general principles, the key question is often whether the insurance proceeds constitute a trading receipt of the recipient – for example, did the insurance proceeds compensate the recipient for a hole in its commercial profits or for the loss of any stock-in-trade? If so, the insurance proceeds may constitute income.

Even if the insurance proceeds do not constitute income pursuant to general principles, specific legislation may impose income treatment. For example, UK legislation provides for insurance proceeds to be treated as trading profits broadly where: (i) there has been a deduction for a loss or expense in calculating the profits of a trade; (ii) the trader recovers the insurance proceeds in respect of the loss or expense; and (iii) the proceeds are not of a revenue nature.

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In the context of W&I insurance, this treatment may be of most relevance where the target holds the policy insofar as the insurance proceeds compensate for losses for which deductions have been made for tax purposes.

Any proceeds not taxed as income may still be subject to tax as chargeable gains. Incorporeal property such as a contractual right will often constitute an asset and, on that basis, the receipt of insurance proceeds could constitute a chargeable disposal, and be subject to tax as a capital gain.

However, exemptions from this treatment may apply. Some jurisdictions specifically exempt certain gains accruing under an insurance policy and, in the UK, there is a statutory exemption where the insurance proceeds are used to restore a damaged asset that was covered by the insurance policy, which may assist.

Practical application

Although the relevant facts, and the applicable local rules, will need to be reviewed in every case, the receipt of insurance proceeds will often result in a chargeable gain, and a corresponding charge to tax, subject to the availability of any exemptions.

In some cases (for example, where the target holds the policy), the proceeds will fall to be taxed as income. Further, in the case of either a "sell-side" or "buy-side" policy, any proceeds subsequently paid to the target may be subject to tax in its hands as income or capital.

Sellers that use insurance proceeds under a sell-side policy to finance a payment under warranties or indemnities in an SPA may be able to avail themselves of a downward adjustment to the consideration accounted for on the disposal of the target, for the reasons set out above. If so, even though the receipt of the insurance proceeds may be taxable, there may be a reduction in the tax payable on the sale of the target.

However, it is important to note that this adjustment may be worthless where the seller had benefited from an exemption in respect of its gain on such sale (for example, under a "participation exemption" in its local jurisdiction).

Parties will likely want flexibility in terms of how the W&I insurance policy is structured to mitigate tax exposures, as the tax treatment could inform the choice of policyholder. While underwriters may prefer to insure the buyer on the basis that it has carried out thorough due diligence on the target's liabilities, the tax consequences of its receiving the insurance proceeds may suggest an alternative approach.

Although more sophisticated policyholders will be able to rely on specialist lawyers and accountants for the tax analysis, the underwriter is frequently expected to possess a basic understanding of the position.

Better informed policyholders will often seek to limit any tax exposures through the use of a gross-up provision in the insurance policy itself, which may place those underwriters that do not offer such comfort at a competitive disadvantage.

Where the underwriter offers gross-up protection, the extent to which the premium should be increased will come under consideration and an understanding of the likely tax result may be relevant to how any uplift should be priced.