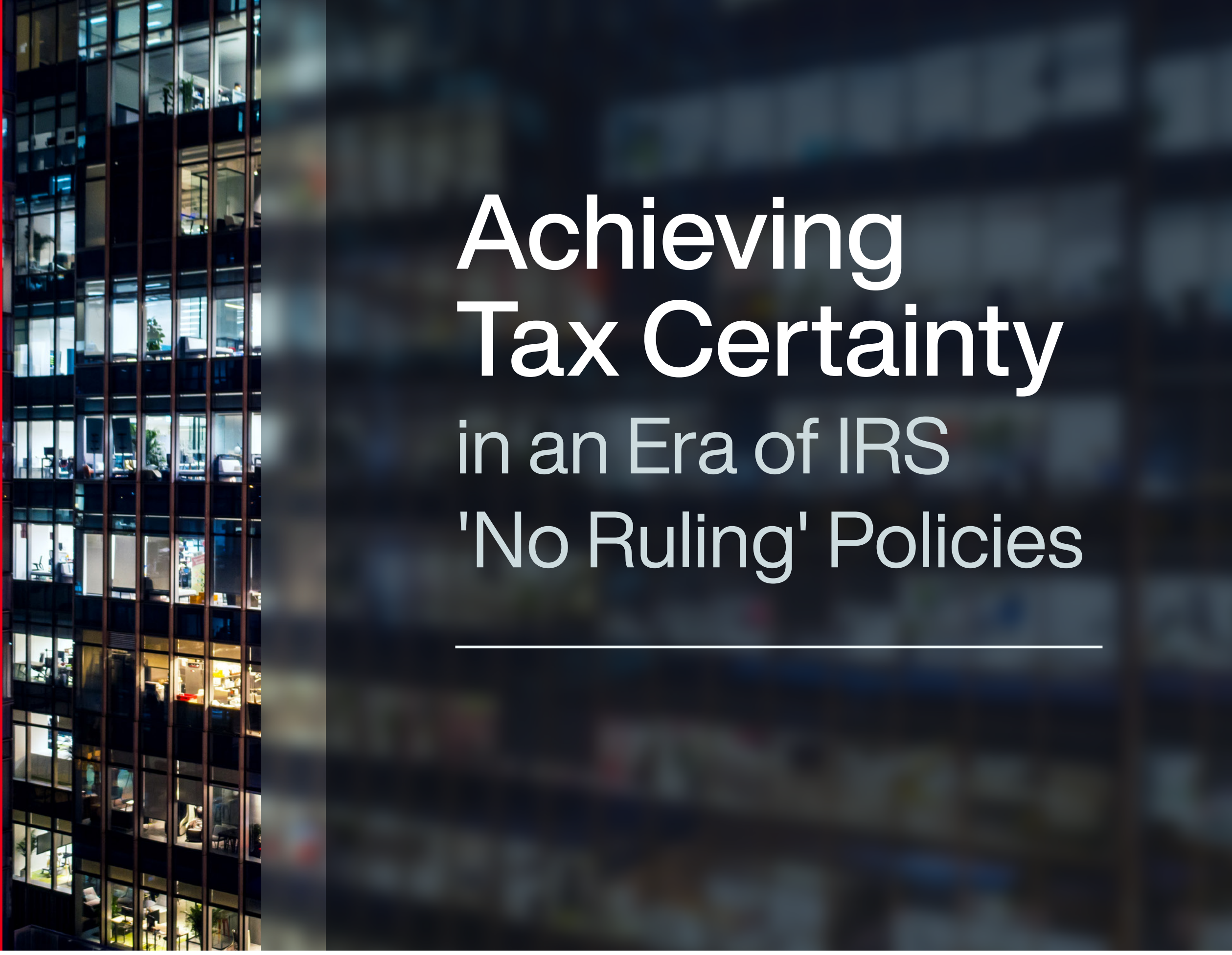


Achieving Tax Certainty

in an Era of IRS 'No Ruling' Policies

It’s no surprise to tax professionals that the Internal Revenue Service (IRS) “no ruling” policy continues to expand. The question our clients are now routinely facing is what to do to achieve that same upfront certainty with respect to the outcome of transactions, restructurings, and tax planning in the absence of a ruling. This issue is particularly relevant in the retirement and benefits field where the IRS has instituted a “no rulings” policy on a number of important issues. As an alternative, tax insurance is an effective tool that can provide certainty should a plan be out of compliance or in the event of unintended tax consequences. While tax insurance has been around since the 1980s and has been a trusted means of gaining comfort on tax exposures in M&A and financing transactions, many do not know that tax insurance can now be used where there is no third party, for example, in the restructuring of a benefits plan.

The potential exposure to our Fortune 500 clients if their tax planning is not respected is often in the hundreds of millions of dollars. IRS Revenue Procedure 2021-3 states the current “no ruling” policy. Of particular interest to our clients are:

- Whether, in connection with a transaction involving the establishment or amendment of a welfare benefit fund (including Voluntary Employees’ Beneficiary Associations (VEBAs)), a transfer of assets between welfare benefit funds (including VEBAs), or a new or different use of assets of a welfare benefit fund (including a VEBA), (i) the employer, plan sponsor, welfare benefit fund (including a VEBA), or covered individuals must include any amount in gross income under Section 61 of the Internal Revenue Code (Code) or the tax benefit rule or (ii) the employer or welfare benefit fund (including a VEBA) have engaged in a sale or exchange of assets under Section 1001 of the Code
- Whether a transfer of assets between welfare benefit funds (including VEBAs), or a new or different use of assets of a welfare benefit fund (including a VEBA), results in a reversion to the employer for purposes of the excise tax under Section 4976 of the Code.

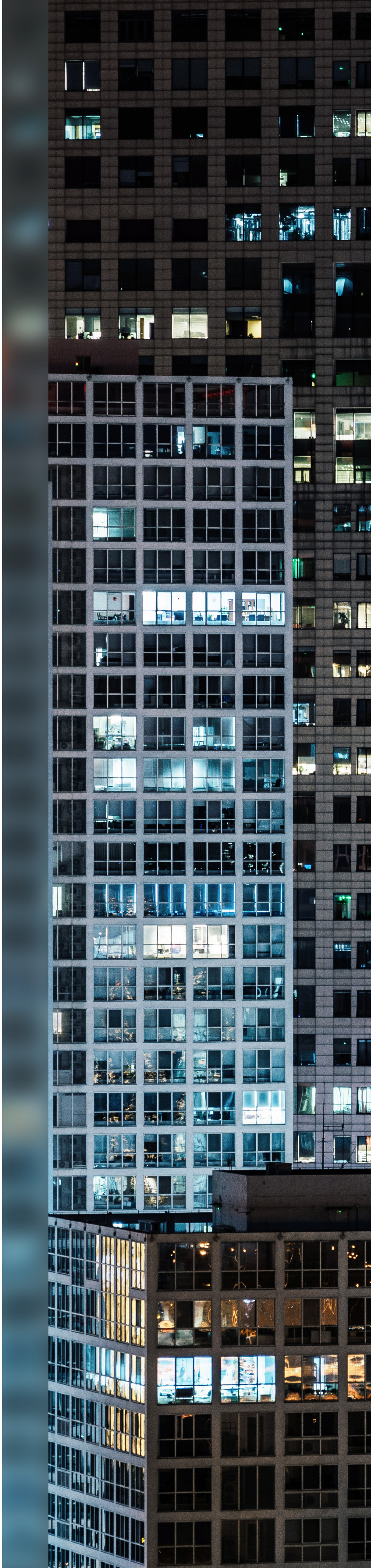
Regularly used as a tool to obtain tax certainty for situations involving U.S. federal, state, local, and foreign transactions, tax insurance is, in effect, the insurance version of a private letter ruling. If an insured tax position is successfully challenged by the IRS or another tax authority, the tax obligation is transferred to the insurers who will pay the additional income, excise, or other tax, interest, penalties, and contest costs, all subject to a gross-up for any tax on the insurance proceeds themselves. In this way, taxpayers can proceed with their restructurings and transactions knowing that if there is a successful tax authority challenge down the road, they will be economically made whole.

The typical tax insurance policy has a seven-year term and is issued on a noncancelable basis. This is generally viewed as sufficient to cover the applicable statutes of limitations. The policy itself typically contains very few exclusions—the principle being a misrepresentation by the insured, which is the same when applying for a ruling. Interestingly, tax insurance also can protect against an adverse interpretation of factbased issues, such as “business purpose,” which would traditionally be beyond the scope of any potential rulings.

Today’s tax insurance market is deep. There are many “A-rated” insurance companies writing coverage, and now insurance programs of over $1.5 billion have become possible. This has broadened insurer appetite for complex tax risks and resulted in historically low pricing.

The potential applications are broad. Insurers routinely insure a wide range of potential tax exposures, including whether benefits plans have been properly administered or restructured under the applicable tax law.

Practitioners should think about tax insurance as a solution for any subject on which they can provide an opinion or situations dependent on third-party valuations being respected. Off the table, of course, are aggressive tax shelters—what the tax world knows as transactions of interest or reportable or listed transactions.

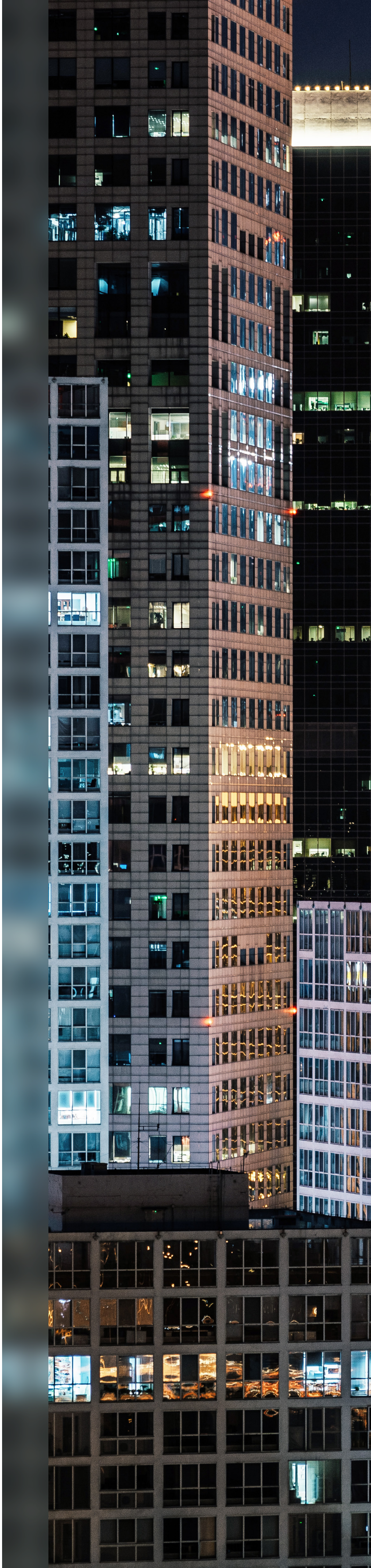


While as noted above the potential applications are broad and often determined by the needs of our clients, we find that examples are the best way to demonstrate the potential application of tax insurance. Here are some other recent examples in the retirement and benefits space beyond just areas where rulings were historically sought.

- **Treatment of Employee Stock Plan under 280G.**
  The employee stock purchase program maintained by a large private manufacturing company raised several tax issues to a client considering its sale. The client was concerned that the tax characterization of payments would not be respected by the tax authorities and amounts were subject to Section 280G of the Code. Aon secured the policy that was part of the indemnification package to the ultimate acquirer.

- **Golden Parachute Excise Taxes under 280G.**
  A company emerging from Chapter 11 was sold to a public company. There was a potential golden parachute excise tax obligation of $10 million if the IRS did not respect the value of the nonsolicitation agreement agreed to by the former CEO. The estate was required to indemnify the departing CEO under his employment contract for this tax risk. As part of the proposed plan of reorganization, funds would have had to be withheld from creditors in escrow to fund the potential tax liability. Aon placed a tax insurance policy to insure against an IRS challenge (this tax insurance policy included the value of the nonsolicitation agreement). As a result, the size of the escrow was substantially reduced, and escrow proceeds were released to creditors to the extent of insurance limits.

- **409A Disqualification—Value of Underlying Stock on Exercise Date.q**
  A leading IT advisory firm purchased a competitor. A few years prior, the target had granted stock options with a specified exercise price per share. At the time of the grant, the target obtained an outside advisor valuation report which valued the target at a lower value per share. Under Section 409A of the Code, a stock option having an exercise price less than the full market value (FMV) of the stock on the option grant date results in adverse tax consequences for the option recipient and a tax withholding responsibility for the company. The buyer purchased a tax insurance policy to cover the risk that post-close, the IRS will successfully assert that Section 409A of the Code applied to the target's stock options—in other words, the exercise price of the options was actually less than the FMV of the target stock on the grant date.

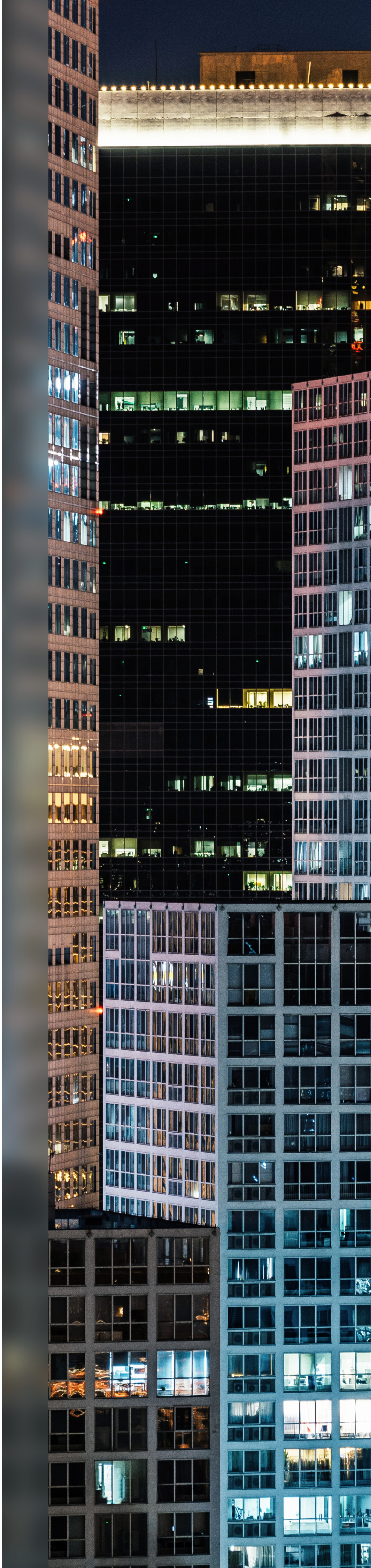


- **Treatment of Replacement Options.**
  A company acquired by a private equity sponsor had outstanding stock option grants that were replaced with new stock option grants as part of a reorganization. The counsel to the seller was confident that the requirements of Section 409A of the Code were satisfied; while the counsel to the buyer was not quite as confident and advised the acquirer to seek indemnification from the seller. A tax insurance policy was used to protect the buyer in lieu of a sellerprovided escrow and indemnity.

- **Treatment of Lapse Restriction Due to Merger.**
  A closely held publicly traded company was pursuing an acquisition of another publicly traded company. The shareholders of the company were participants in a restricted share plan that provided that the restrictions would lapse if the founding family's ownership fell below a specified level. As a result of the planned acquisition, the founding family's ownership would fall below the specific level, resulting in a taxable event. The shareholders sought certainty that the lapse of these restrictions as a result of the acquisition was not a compensable event. Aon placed a tax insurance policy to provide certainty in this regard.

- **Withdrawal Liability to Multiemployer Pension Plans under ERISA.**
  A large public company obligated to contribute to a multiemployer pension plan was selling key assets to a private equity firm. The transaction was structured as an asset sale intended to avoid withdrawal liability under Section 4204 of the Employee Retirement Income Security Act of 1974 (ERISA). Facing a fast-moving transaction, the seller obtained a tax insurance policy for any potential liability should the sale not be respected as an exempt asset sale rather than seeking indemnification from the buyer.

The narrowing of the IRS ruling policy is a trend that is likely to continue as the agency struggles to apply its limited resources to tax collections. Yet, taxpayers seek certainty before making a material tax move even when advisers can provide them with strong tax advice. Tax insurance can fill that void in a time efficient manner, and at a very cost-effective price.



AON

Contact us:

Gary Blitz

Global Co-CEO,
M&A and Transaction Solutions

+1 301 704 4640

gary.blitz@aon.com

Jessica Harger

Managing Director,
M&A and Transaction Solutions

+1 914 572 2422

jessica.harger@aon.com

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