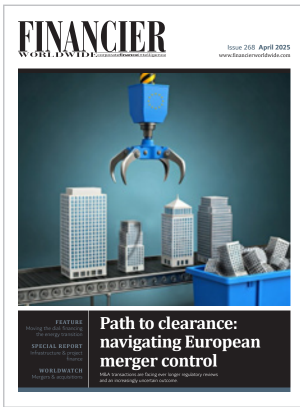

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Managing multinational tax risks: the role of tax liability insurance

FW discusses the role of tax liability insurance in managing multinational tax risks with Romain Tiffon at ATOZ Tax Advisers S.A.

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FW: Could you provide an overview of the tax risks and exposures that you have encountered to date?

Tiffon: 2024 saw a sharp rise in the number of risks and exposures being covered by tax liability insurance (TLI). Last year was a challenging year for the real estate market, which experienced notable declines in property valuations. This often led to debt events of default, triggering broader restructuring consequences. In that context, we have encountered several cases where shareholder debt was waived, raising the question of whether that debt cancellation could result in a taxable gain. As a matter of principle, a debt release triggers an accounting and thus tax profit. However, in the context of a financial recovery situation, there is tax exemption for debt release which requires the fulfilment of specific conditions. Additionally, where the debt release occurs between associated enterprises, other tax considerations may be triggered. Given the uncertainties as to a debtor's benefits arising from the financial recovery debt waiver and the quantum of the exempt shareholder debt release, insurance may be obtained by debtors to cover any potential taxable profit that could result from the amount of the debt waived to enable a swift liquidation of companies. Structures involving classes of shares have been common in Luxembourg for around two decades. However, this was based on market practice, and it was only in 2024 that the tax treatment applicable to share class redemptions was legislated. Prior to enactment of the law but after the draft law was issued, a company repurchased a class of shares that it had issued prior to the draft law, and the question was whether this could be qualified as a dividend distribution that could otherwise be subject to a 15 percent withholding tax. Despite existing market practice, case law on the matter and a draft law clarifying the tax regime that has since become law, in the context of the forthcoming liquidation of the companies and the fund that held these companies, the taxpayer wanted to remove any residual withholding tax risk around that share redemption and consequently obtained insurance.

FW: To what extent are you seeing a rise in tax authorities challenging tax positions taken by taxpayers in your jurisdiction? How are their attitudes and methods evolving?

Tiffon: According to the latest activity report issued by the Ministry of Finance, the number of tax appeals submitted to the director of the Luxembourg tax authorities reached 1832, up from 1710 in 2022 and a 57 percent increase over the last 10 years. This increase is largely driven by the growing complexity of tax legislation and a lack of clear guidance from the Luxembourg tax authorities, thereby giving

them significant interpretational discretion. The report further highlights that less than 15 percent of the decisions taken by the director of the Luxembourg tax authorities are challenged before the Administrative Tribunal. To address the constantly rising number and complexity of tax litigation cases, a division of the Administrative Tribunal specialising in tax was launched in September 2023.

FW: What options are available to taxpayers looking to improve the way they manage tax risks across jurisdictions?

Tiffon: There are various options that taxpayers may adopt to manage tax risks across jurisdictions. These options are usually contingent on the business model of each taxpayer, so this should not be considered a 'one size fits all' approach. The most obvious one relates to compliance. Enhanced tax risk management requires transfer pricing compliance alongside general corporate tax compliance. This imposes on companies a more readily available data set and requires that transactional documentation be prepared in line with Organisation for Economic Co-operation and Development transfer pricing guidelines on or around the transaction date. On the back of this compliance dynamic, one should not overlook the role that artificial intelligence (AI) and more precisely generative AI (GenAI) can play in the compliance sphere. GenAI has the capacity to extract, classify and categorise company data to populate tax forms, thereby leading to more accurate and faster reporting. This is even more pertinent to companies operating globally, which may consequently have to utilise a single data point for several data outputs in multiple jurisdictions. Tax authorities themselves are increasingly digitalised and adopting AI tools to conduct tax audits and review tax filings. One thing that we believe should be maintained is a communication channel between taxpayers and the tax administration. It is critical these parties engage in regular dialogue on key structuring questions, as this will help taxpayers stay compliant with regulatory changes while allowing tax authorities to understand key business drivers, and thus maintain Luxembourg's prominent position as a world class financial and fund centre.

FW: Could you outline the role tax liability insurance (TLI) can play? What are the typical strategic uses, scope and placement issues associated with this type of insurance?

Tiffon: TLI is a bespoke insurance product designed to protect businesses from unexpected financial losses due to disputes with tax authorities over their tax liabilities. These disputes may arise from audits, changes in the interpretation of tax laws, or challenges to specific tax positions taken on various transactions, such as M&A, internal restructurings or cross-border operations. Given the complexity and evolving nature of tax regulations, TLI is a powerful tool that helps businesses mitigate financial exposure and navigate tax-related uncertainties with confidence. TLI serves a dual purpose in that it offers financial protection as well as ensures peace of mind for businesses facing potential tax disputes. The key objectives of this insurance product include financial protection against unforeseen tax liabilities where TLI shields businesses from unexpected tax assessments that could arise due to a challenge from a tax authority, mitigation of risk associated with tax positions where TLI helps manage the uncertainty surrounding tax treatments, particularly in complex financial transactions or international operations, and facilitation of dealmaking where TLI can ease negotiations between buyers and sellers by resolving concerns about contingent tax exposures. TLI policies generally provide coverage for various aspects of tax-related financial exposure. This may include tax liabilities. In that case, if a tax authority successfully challenges a tax position, the insurance covers any additional taxes owed. It may also cover interest and penalties, in which case the policy would reimburse the insured for interest and penalties imposed as a result of a tax reassessment. Moreover, defence costs, which may relate to legal and accounting fees incurred in defending the tax position against

the authorities, can be covered in the policy.

FW: What are the key features of a TLI policy? What factors may impact factors such as pricing and exclusions?

Tiffon: One of the primary functions of TLI is to cover financial exposure resulting from tax reassessments. If a tax authority determines that a policyholder owes additional taxes, the policy would reimburse the amount due, including any associated penalties and interest. TLI can also play a critical role in tax litigation. Tax disputes can be complex and require significant legal and accounting expertise that can be tremendously costly, and TLI can typically include coverage for the fees incurred when defending against a tax audit or challenge. Another feature of TLI is the role it can play to protect against specific tax risks. TLI policies are often tailored to cover tax positions or deductions that may come under scrutiny. In addition, TLI can provide protection for tax positions taken in previous years, covering exposures that might be challenged later by tax authorities. This could be the case where the value of a deferred tax asset is linked to the headline rate, for example. TLI policies can be customised to fit specific needs, and consequently coverage terms may be adjusted based on factors such as the nature of the tax risk, jurisdiction and duration of protection required. On the latter point, the coverage is usually aligned with the statute of limitations for tax audits in the relevant jurisdiction. Several elements impact the cost of obtaining TLI. The most obvious is the complexity and level of risk associated with a tax position. Structures that involve intricate transfer pricing strategies or a significant financial stake will generally attract higher premiums in the underwriting process. Where a tax position is backed by well-founded documentation and counsel opinion, this conversely leads to a lower premium. Another consideration that is not taxpayer-contingent is the country where the tax risk exists, because this will drive the counterparty in the tax risks: the tax authorities. It is common knowledge among tax experts that some tax authorities are more aggressive in their auditing practices, which thus has a direct impact on the likelihood of disputes. In addition, some countries have a constantly evolving tax landscape, which increases uncertainty. As with any insurance policy, a TLI policy comes with exclusions. These are bespoke to the relevant TLI but one should work on the assumption that where an insured party knowingly misrepresents information or engages in tax fraud, coverage will be denied. In the same vein, it is typical that criminal penalties arising from tax evasion or other illegal tax practices are excluded from policies.

Given the complexity and evolving nature of tax regulations, TLI is a powerful tool that helps businesses mitigate financial exposure and navigate tax-related uncertainties with confidence.

ROMAIN TIFFON
ATOZ TAX ADVISERS S.A.

FW: In the event of a dispute with the tax authorities, what steps should insureds take in conjunction with their insurer?

Tiffon: If an insured party faces a dispute with the Luxembourg tax authorities, it should take a number of steps in conjunction with its tax liability insurer to ensure smooth claims handling and maximise coverage benefits. It should notify the insurer immediately, as this is

generally a condition in the policy, and provide the insurer with all relevant documentation, such as tax filings, correspondence with tax authorities and legal opinions supporting the disputed tax position. Additionally, the taxpayer should contact its tax experts as well as lawyers, as they will assess the strength of the case. Depending on whether the TLI policy covers defence costs, it may be necessary for the insurer to approve fees. Once these stakeholders are assembled, a defence strategy should be developed to maximise the chance of success.

FW: What essential advice would you offer to taxpayers on structuring a TLI policy that best suits their particular needs?

Tiffon: Before making a selection, it is important to understand the process of obtaining a tax insurance quote. Once a tax risk is identified by the taxpayer, it will share this with an insurance broker that will perform due diligence, reviewing the project and giving a preliminary view on what the achievable cover might be. Depending on the outcome, the broker will reach out to several underwriters operating under confidentiality agreements. At that point, the underwriter can assess the technical position around the risk with a view to the deployment of capital. The underwriter may then issue heads of terms, which is a non-binding indication, for the risk. This offer will include the premium, the nature of the cover and any exclusions. Once the broker receives heads of terms, it will summarise the responses along with the quotes, for the client to then select an underwriter. On the taxpayer's end, it is critical to properly identify the tax risk being submitted to the broker for quotation. This will require assembling the right documentation, which may include any tax opinions issued by counsel at that stage. Duration of the policy is an important feature, and this may well have an impact on pricing. With the support of advisers, the taxpayer should determine an optimal duration for the policy. Finally, a thorough understanding of policy exclusions and limitations is essential, as it may heavily influence the choice of underwriter.

FW: Looking ahead, what developments do you expect to see in TLI over the months and years ahead?

Tiffon: Expansion of TLI is contingent on the growth of tax risks. Amid constant regulatory changes and the evolving complexity of the tax landscape – both domestic and international – it is likely that the number of deals being insured in the TLI market will grow. Taxpayers will need more tailored policies, with broader protection. For comparison, a few years ago, transfer pricing could not be insured whereas today this is possible. The tax authorities, thanks to digitalisation, will be more active and possibly more aggressive on the tax audit front. The consequence is that the number of claims and reclaims will increase. Despite Luxembourg being a small jurisdiction, the number of tax appeals grew by 57 percent over the past 10 years, without commensurate increase in the number of tax inspectors. What this means is that the reclaim procedure is likely to be lengthier – the latest statistics in Luxembourg show that, on average, there is an 18-month interval between conclusion of the written procedure and the oral hearing. This may lead to operational and cash management concerns for taxpayers. In a private capital context, that would mean a taxpayer cannot be liquidated pending the conclusion of a claim, and generally must prepay the tax even if ultimately it is not due, which means cash cannot be returned to investors, thus impacting the performance metrics of an investment fund. This is not ideal, and here the TLI product may permit the release of capital back to investors, preserving fund performance, allowing the liquidation of companies involved, and reducing maintenance costs – all for a premium paid to an insurer likely to have a deep appreciation of how to price the risk. ■

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