Rethinking the Approach to

Corporate Tax Reserves

How Tax Insurance can be Leveraged

Tax reserves for uncertain tax positions maintained by US companies are substantial. Over 25 Fortune 100 companies disclose such tax reserves with values exceeding $100 million. Uncertain tax positions can have a negative effect on earnings. Companies must reserve funds when the auditor is unable to get comfortable with a tax position, and this liability on the balance sheet drags earnings down. The earnings drag will continue until the IRS review period expires, during which time the company is exposed to the real possibility of an adverse view by the tax authority that can deplete the reserve for good.

Tax insurance has traditionally protected companies against the failure of a transaction or tax planning to qualify for its intended tax treatment, resulting in an unanticipated or ill-timed cash tax loss. It is a proven, efficient and cost-effective tool to bring certainty to the treatment of a US, state, local or foreign tax position. But there is a broader positive application that can be accretive to a company's earnings, due to favorable accounting treatment under US GAAP. Interestingly, today's tax insurance capacity per risk exceeds the average tax reserve posted by Fortune 100 companies.

A Big Four accounting firm has provided Aon with guidance on the proper accounting treatment of tax insurance and its impact on the financial statements. They confirmed that tax insurance can, indeed, impact FIN 48 reserves positively and similarly affect corporate earnings and balance sheets where uncertain tax positions have been recognized. By purchasing tax insurance, companies can transfer the full or partial risk from the tax exposure to the tax insurers, releasing a liability and a corresponding full or partial credit to income. This potentially results in higher earnings, a lower effective tax rate, and higher share price.

Tax insurance has grown and evolved into a major risk management tool. Today, with the maturation of the market, tax risks unrelated to an M&A transaction are routinely covered. CFOs, controllers and corporate tax professionals now have a tool at their disposal that can not only manage risk, but can be strategically leveraged to have a positive impact on their company's earnings.

It is important to be aware that tax insurance is not a vehicle to avoid reporting and disclosure requirements under US GAAP applicable to aggressive tax positions, and many positions for which reserves are maintained are not insurable. However, for uncertain positions where companies have conservatively posted a tax reserve, notwithstanding positive tax advice of counsel, accountants or other advisors, tax insurance may offer a means to avoid or reverse the income statement hit associated with recognition of the uncertain tax position. Companies should consult with their own tax advisors and Aon for advice with respect to a specific transaction or situation, and its insurability.

"As one of the first professionals to work with tax insurance, I have witnessed the dramatic growth of this industry in both size and scope," says Gary Blitz, Sr. Managing Director and Head of Tax Insurance at Aon. "Now, both corporations and their auditors are becoming more comfortable using it as a strategic financial tool that can receive favorable accounting treatment. This has accompanied a marked change in the value proposition in the sense that today substantial limits are available at a cost that is half of what it was not many years ago."

Tax Insurance in Action

A major US transportation company takes the Tax Code Section 199 domestic production deduction related to online software development of its internal booking engine. It has a tax opinion from its tax advisors at a "more likely than not" level of assurance (a likelihood of more than 50%) that the deduction is a proper tax position. However, the company's auditors take a more conservative view than the "more likely than not" guidance from the tax advisors, and accordingly have required the company to treat the tax position as an "uncertain tax position", and record a FIN 48 reserve on its financial statements. This reserve has remained in the liabilities column, tying up these funds for several years.

Aon placed a tax insurance policy for the company that protects the company from cash taxes in the event of an IRS or state challenge on the availability of the deductions. In addition, the adverse impact of the FIN 48 reserve should be neutralized and the attendant hit to earnings avoided because of the risk transfer to the tax insurers.

To learn how Aon can help you realize certainty for your organization, contact:

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