

Tax Insurance for Directors

"Anyone may arrange his affairs so that his taxes shall be as low as possible," said Judge Learned Hand in one of his most celebrated opinions. "There is not even a patriotic duty to increase one's taxes. Nobody owes any public duty to pay more than the law demands." Between 1996 and 2000, 60% of U.S. companies were able to follow that sage advice to the point that they paid no income taxes at all. And doubtless the 40% that did took every deduction they could. But unlike most other expense items, taxes are subject to reinterpretation by the courts and the IRS, which means one more headache for boards already trying to cope with various reforms. For example, can the money a company thinks it will collect by way of a tax refund be safely invested in capital improvements, or will the government come after it at some future date?

Corporations have been able to insure themselves against such eventualities for some time, through policies offered by American International Group, among others. The premiums typically run from 5% to 8% of the tax sum that might be challenged. One airline, assuming that it would be getting a tax refund of \$300 million, paid Risk Capital Partners, a New York City insurance brokerage, a one-time premium of \$15 million to insure against losing the refund over the course of the next seven

years—by which time the IRS would presumably have decided to rule one way or the other.

Risk Capital has now introduced coverage to protect individual directors should the IRS "come back and bite the company," as Nemo Perera, a managing partner at the firm, describes unfavorable rulings. If that happens, shareholders can go after the directors for approving the offending tax strategy. The new coverage, says Perera, will give board members protection to add to the directors' and officers' insurance they already have.

Among those endorsing this sort of coverage is Bob Williamson, former CFO of the computer-hardware manufacturer Equinox Systems in Sunrise, Florida, and a director of Miami-based Therapy Review Systems, which runs therapy programs for managed-care plans. "Insurance gives us the opportunity to look shareholders in the eye and say we're mitigating the risk on this," he says.

Such policies, whether for companies or their board members, also serve as an alternative to the expert opinion lawyers and accountants have traditionally provided in stating that a planned tax strategy is legal. Getting insurance is in itself an expert opinion that the plan is sound, says Perera: "The insurer, for a premium, substitutes his capital for the board and management's best guess as to what an opinion

letter might mean." Conversely, a refusal to offer insurance represents an opinion that the strategy is a bad idea, and this don't-do-it advice comes cheap. "One doesn't even have to buy the insurance," Perera says. "Simply paying for the underwriter's due diligence provides an answer."

Meanwhile, new tax regulations will choke off the income from what IRS commissioner Mark W. Everson has called "the lucrative trade in opinion letters" that lawyers and accountants have enjoyed. For one thing, they can no longer collect commissions on transactions they bless with

these opinions, a practice that has been commonplace.

Both Perera and Williamson say that the IRS looks "very positively" on tax insurers, viewing them as the only nongovernmental entity motivated to judge tax positions conservatively. Even if the IRS challenges a strategy that an underwriter thought would work, the policyholder wins: Insurance money will take the place of what the board thought it would save on taxes.

A win-win situation with the IRS—now that's strategic planning.

by Stewart Kampel

