

IN THE MONEY: Insurance Plan Covers Kerry Tax Cut Hit

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NEW YORK (Dow Jones)--It goes without saying that big business loves a tax cut.

But here's a little-known technicality that may not be so popular with some major companies.

Oddly enough, Democratic presidential candidate John Kerry's proposal to cut the corporate tax rate to 33.25% from 35% could present a problem for businesses with large deferred tax debits on their books. One European company is even insuring itself against an even greater tax cut.

Deferred tax debits occur when companies have accrued a taxable expense but not yet made the tax deduction. A prime example is post-retirement health care benefits; companies must set aside cash now to cover future benefits for their employees, but they can only take the tax deductions when the benefits are paid.

Under GAAP, companies can account for this by turning these debits into deferred tax assets based on the tax rates at the time. They can list these assets on their balance sheets and cash flow statements until they eventually take the deductions.

For companies with these on their books today, the Kerry tax plan's a problem. Any change in the corporate tax rate reduces the amount of money they can list as deferred tax assets. That'll mean taking charges on their income statements.

Here's how it works: Say a company has \$1 billion in expenses it can deduct in future years. At the 35% corporate tax rate, this company generates an asset of \$350 million from its deferred tax debit. It counts this as income on its cash flow statement.

If Kerry wins Tuesday and cuts the corporate tax rate to 33.25%, that asset's now worth only \$332.5 million. The company would have to take a \$17.5 million hit simply because the law had changed.

It turns out that large banks and finance companies are particularly sensitive to this situation because they "sell their balance sheet" - their businesses are based on their perceived ability to wisely lend or invest their money.

Since these large banks regularly shuffle large sums of money around their balance sheets - setting up reserves for loan losses and other items - they can create hundreds of millions of dollars in taxable expenses that they can deduct in future years. This leaves nice sized deferred tax assets listed on their books in the current year.

And because any reduction in balance sheet strength can have dire implications for these banks in the financial markets, they're often eager to mitigate wild fluctuations in their financial results.

Indeed, Risk Capital Partners, a boutique insurance brokerage and consulting outfit with offices in New York and Los Angeles, recently was approached by a "major European bank" about creating an insurance plan to deal with just this problem. And after doing a little research, Risk Capital Partners found it could create a policy to protect the bank in case Kerry enacts his corporate tax proposal.

"Once we saw what they were talking about, that they would lose value if the new law was adopted, we thought that we might be able to help them," said Nemo Perera, a principal and co-founder of Risk Capital.

The Risk Capital policy works like a traditional insurance policy, where the company calculates its exposure to the new tax law and then pays Risk Capital to insure that amount.

The European company has about \$1 billion in deferred tax debits on its books, so it stands to lose \$17.5 million in assets on its books. But the company, concerned that Kerry's tax cut may be deeper, has taken out a \$50 million policy with Risk Capital, costing between \$7 million and \$9 million. It would cover a two-year legislative cycle, reflecting the fact that Congress could take its time passing any proposals by a new administration.

In effect, Risk Capital is betting against Kerry winning and passing his corporate tax bill within the first two years. If he does, Risk Capital will have to pay up. If Kerry loses, or is slow to pass the bill, it pockets the premium.

Tax specialists said they weren't surprised by the creative financial thinking.

"I kind of expected this," said Robert Willens, a tax and accounting expert at Lehman Brothers. "Whenever we get a change in tax rates we see these insurance ideas crop up."

Willens also pointed out that there's a growing cottage industry of insurers willing to cover the esoteric tax risks of some complicated financial maneuvers, such as spin offs and the like.

Perera said he isn't aware of any other insurers that are writing these specific policies. And now Risk Capital is beating the bushes to see if there are any other multinational finance companies interested in this kind of coverage.

"It's a pretty specific problem," Perera said. "But there are a number of very large companies in this situation - 20 or 30, or maybe more."

More is right. Willens said that beyond the finance arena, many major industrial companies, like General Motors Corp. (GM) and Ford Motor Co. (F), have billions of dollars in deferred tax assets that could be insured.

Remember though, it might not always be convenient for companies to book a deferred tax asset for future benefit obligations. Tax gains or losses elsewhere on the books might dilute their usefulness.

Perera said that although the European bank remains its only customer for the policy, Risk Capital is in talks with several other "global financial institutions" as well. He added that while Risk Capital hasn't contacted any businesses outside of the banking and finance sectors, the company is prepared to insure anyone in this situation, regardless of the size of their deferred tax assets.

With the election only days away, Risk Capital might only have to wait till Wednesday, rather than November 2006, to pocket the premium.

As the saying goes, you can't insure everything. But in this election cycle it looks like you can come pretty close.

(Eric J. Weiner is one of four "In The Money" columnists who take a sophisticated look at the value of companies and their securities and explore unique trading strategies.)

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