

The Tax Implications of Rep and Warranty Insurance

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In purchase and sale transactions, the parties can obtain insurance to compensate them for financial loss arising from inaccuracies in the representations and warranties made in the purchase agreement. Popular in the USA, “R&W” insurance for Canadian purchase transactions is still somewhat novel. As a result, the tax implications of such insurance have remained largely unexplored.

To understand the tax implications of R&W insurance, it is important to understand how R&W insurance works. The party that pays for the R&W insurance is negotiated as part of the transaction and largely depends on which party requires the insurance. In some cases, the seller prefers to obtain R&W insurance, rather than a holdback or escrow of a portion of the purchase price. In other instances, the buyer requires the insurance to satisfy its lenders.

The premiums for the policy typically range from 4-8% of the insured amount, payable in one instalment, for the entire term of the policy. There is a flat underwriting fee payable to the insurer for undertaking the due diligence process required to insure the transaction, regardless of whether or not the policy is written. The term of the policy is normally the applicable limitation period of the insured R&W.

The tax treatment of the premium as well as any payout under the policy is dependent upon on who is paying the premium and receiving the payment. Different alternatives are discussed below.

Seller Pays Premium

Typically in a seller-side policy, the seller is the beneficiary and the party making a claim under the policy. If a seller R&W is breached, the seller makes a claim under the policy and insurance proceeds are paid to the seller, who then makes a payment to the buyer in the form of an indemnity payment. If the seller pays the R&W premium, it is likely that the premium will be considered to be a cost incurred to implement the sale of the transaction property. This cost will be deducted in calculating any capital gain (or loss) realized by the seller on the sale of the transaction property.

Buyer Pays Premium

In a buyer-side policy, the buyer is the beneficiary under the policy and the party making a claim under the policy. Any payout under the policy is paid directly to the buyer. If the buyer purchases the policy, the premium paid will likely be added to the cost amount to the buyer of the transaction property.

Payment Received Under the Policy

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A purchase agreement generally specifies that indemnification payments received or paid are treated as adjustments to the purchase price of the transaction property.

If the seller receives insurance proceeds and makes an indemnity payment to the buyer, as a result of the surrogatum principle, the insurance proceeds will be taxed in the same manner as the payments they are intended to replace; in this case, the purchase price. Since the purchase agreement will reduce the purchase price by the amount of any indemnity payment made by the seller, and the insurance proceeds replace the reduced purchase price, it is likely that the payments will offset each other for tax purposes.

However if a buyer receives insurance proceeds directly, that is not an indemnity payment under the purchase agreement and therefore not an adjustment to the purchase price paid. As with proceeds received by the seller, insurance proceeds received by the purchaser will be taxed in the same manner as the payments they are intended to replace. If the parties intend to have any insurance proceeds received by the purchaser to be an adjustment to the purchase price, this should be clearly stated in the purchase agreement.

As the tax implications of R&W insurance depend on who pays for the premium and who is insured under the policy, these implications should be considered when negotiating the terms of the purchase agreement and prior to the purchase of the policy.

This publication is a general summary of the law. It does not replace legal advice tailored to your specific circumstances.