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Monetizing **Tax Refunds**

By Roy H. Reynolds

In today's market of tight liquidity, some companies are cashing in now on tax refunds that may be due in the future. Tax refund insurance can be used to turn a future tax refund into a valuable source of immediate cash. Some examples are: (a) a large, corporate refund can take up to a year, (b) preparing a refund request, waiting for the IRS to process it, and receiving the check takes time. In the meantime, a company may suffer from a lack of liquidity that puts it into default with its lenders or restricts its working capital. Certain law firms and investment banks, and structured finance companies can syndicate such refunds and sell them to investors for cash. Commercial banks, investment bankers and money managers can make bridge loans, using the insured tax refund as collateral.

In order to borrow against a potential tax refund, a company must be able to provide secure collateral. To remove the uncertainty associated with a tax refund that has just been claimed or is about to be claimed, the insured can obtain an insurance policy from a highly rated insurance carrier. The policy pays if the insured fails to receive a refund of a specified amount by a certain date. The policy provides very limited exclusions, so that the lender can be sure that the collateral is solid. Terms and conditions can be negotiated to satisfy the lender.

Lenders are willing to loan against an insured tax refund, says a source from a major bank. To facilitate the loan, the borrower must assign the IRS refund to the lender and designate the lender as the loss payee under the policy. The loan can be structured with current interest payments, or issued at a discount. The loan requires certain actions to be taken by the borrower, or the lender will have the right to step in. For example, if the borrower fails to file the refund request to make a claim on the insurance, the lender has the right to take those actions on the borrower's behalf.

Case Study

Company A is a small, New York-based, information technology firm, whose customers are primarily in the financial services industry. Company B is a Florida-based mortgage lender and Company A's largest customer. Company A provided and billed approximately $5 million worth of network engineering services to Company B. Subsequently, Company B disclosed heavy losses and declared bankruptcy. Company A uses the accrual basis of accounting, so it had already included the $5 million of services in its 2006 revenues. Because of the financial status of Company B, Company A concludes that it will have to write off most of that revenue as a bad debt. Company A files an amended return for the 2006 tax year, claiming a tax refund based on reduced net income attributable to the bad debt.

Company A itself is suffering from a lack of liquidity and risks violating its loan covenants. It approaches its bankers, but is unable to obtain an additional unsecured loan. Company A negotiates with its bank to provide a loan against the tax refund. However, the bank requires that Company A insure the tax refund with a highly rated insurance carrier, to provide secure collateral for the additional loan. Company A obtains the tax refund insurance, gets its loan, diversifies its customer base, and weathers the liquidity crisis.

Conclusion

In the words of Nemo Perera, managing partner, Risk Capital Partners, "Tax refund insurance is particularly suited to middle market companies that need capital and lack sufficient credit to borrow the necessary funds. Because of the secure collateral, the cost of funds is lower than it would be without the insurance." ◻

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