TAX LIABILITY INSURANCE AND REAL ESTATE: HOW TO BUILD A SOLID FOUNDATION

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AON

In a context where investors are more sensitive to the risks arising during the investment cycle, it is not surprising to observe that Tax Liability Insurance is more and more frequently used in Real Estate transactions in France, and more generally across Europe. Its scope actually goes beyond transactions as it is now used as an efficient tool to address various types of tax issues at any stage of the whole lifecycle of Real Estate investments. It now has a solid track record of both facilitating transactions and securing the tax impact of the ownership structure.

You mention that the RE industry resorts more and more to Tax liability Insurance, can you summarize what this product achieves?

Tax liability or tax opinion insurance can help a company reduce or eliminate its exposure to the identified risk of a loss arising from a successful challenge by a tax authority of the expected tax treatment of a proposed or historic transaction. It covers the losses arising from the failure to achieve the expected tax treatment, i.e. the tax, the contest costs, interest, penalties and gross up.

It is a great way to have visibility on the total return of a transaction in an industry that is highly sensitive to the overall level of taxation of the investment.

What kind of services can a Tax Insurance broker offer to its real estate clients?

At Aon, we assist our real estate clients through the entire real estate life cycle – from the acquisition of the property or the shares of the propco, to their disposal. We intervene at every stage of the real estate transaction value chain for all types of players in the sector, RE funds, REITs, promotors, the hospitality or logistic industries, or even corporates.

In terms of tax risks, they can relate to the property itself, to the vehicle holding the property or to the tax treatment of the transaction. They can also relate to the ownership structure. Where such risks are identified, we can assist with the placement of Tax Insurance.

Our goal with assisting our client with the placement of these products is twofold – to facilitate the real estate transactions (both on the buy-side and on the sell-side) and to maximize returns on investment for our clients. As a proven solution for facilitating transactions, Tax Insurance products have grown exponentially in the last two years, in spite of the slow-down of the activity.

How can Tax Insurance be helpful to a real-estate actor?

As we know, the RE market has slown down, the number of transactions has decreased, in part because of difficult financing conditions. In this context, all transactional tools that can help get the deal through should be explored by the parties. Also, in a deal environment where sellers are accustomed to having a "clean exit" in their deals, insurance is a great alternative to the traditional deal protections of a price chip or a specific seller indemnity.

The most sophisticated sellers sometimes proactively approach the insurance market ahead of an exit process. If the vendor due diligence has highlighted a material tax risk, the seller can seek competitively priced insurance quotes which can then be used to either cover the indemnity granted to the buyer or have the risk insured at the level of the buyer.

Symmetrically buyers both improve the quality of their offer and the visibility of the return on their investment by outsourcing the risk to an insurer.

When we think about Tax Insurance, we traditionally think about covering the identified tax risks of the target. Is it relevant in the case of real-estate transactions?

When it comes to identified risks, they can be quite varied in the real estate sector and can jeopardize the completion of the project. Risks of the target such as the well-known French 3% tax, interest rates of shareholder loans, the benefit of tax-exempt regimes, just to name a few, are frequently insured.

But the term target is not fully appropriate when it comes to Real Estate transactions, or rather, does not include all that the tax insurance covers since asset deals can also benefit from Tax Insurance. In the context of asset deals, we've assisted clients with insuring the risks relating to the property itself such as the "new building" characterisation, "*reprises d'engagements de construire*" (assumption of building commitments) or liabilities to local taxes attached to the property.

However, Tax Insurance now has a broad scope that is not limited to the risks identified during the due diligence process and associated with the target or the assets.

How and why did Tax Insurance evolve to cover other risks than the risks of the target or of the asset?

Initially, Tax Insurance was aimed at investors wishing to cover the risks of the target or the asset in an acquisition process, thereby providing security to both parties and, equally importantly, greatly simplifying the negotiations between them. Soon after, the players on the RE market realised that there was no reason why the risks of the transaction itself, which could also block a transaction, or considerably slow down the negotiations, could not be covered by this solution.

Tax Insurance can really help enable a seller and a buyer to agree to a preferred deal structure without taking on additional tax risks by covering the risks of the transaction itself. In many instances, the preferred transaction structure of either the seller or the buyer may entail risks for either party and negotiations can then become complicated. Tax Insurance, by covering the risk thus generated by the preferred option, greatly facilitates the negotiations. We see clients who tell us that without the insurance, the deal would not have gone through.

Could you give an example of risks related to the transaction in the case of a real-estate transaction?

To take a simple example, the application of the VAT exemption to the sale of a property deemed to be a transfer of a going concern, or "TOGC" (a "universal transfer of assets" under French law) is frequently uncertain. Even when the question seems benign because the treatment can be corrected if both parties have agreed to it in the event of a future challenge by the tax administration, the risk that the seller, or the buyer in some cases, may no longer be in existence at the time that the correction must

be made, or even the question of the financing of the VAT in these specific cases, can delay, or sometimes even jeopardize the completion of the transaction. Covering the risk through Tax Insurance is the perfect remedy to these situations.

A subject we also have encountered on several occasions is the "Real Estate Transfer Tax", or "RETT" treatment that is expected to apply upon disposal of the shares of an entity holding real-estate. The amounts at stake can be very material, and the negotiations around who should bear the risk are often painful… until the risk is covered by Tax Insurance. In these cases, Tax Insurance will cover the RETT treatment of the transaction in the case where the entity would be requalified as a property-rich entity by the tax authorities.

Can Tax Insurance have a direct impact on the Internal Rate of Return (IRR)?

As mentioned above, Tax Insurance allows to eliminate the tax risks identified in the course of acquisitions, thereby providing an obvious upside to the IRR of the investors.

Outside of an M&A transaction, tax insurance can also protect the intended tax implications of fund structures. We regularly assist real-estate funds and real-estate companies to secure their corporate income tax exemption, that is subject to compliance with several conditions set out by law. We have assisted REITs or tax-exempt real-estate funds with securing the corporate income tax exemption they were relying on. Tax insurance allows to prevent a tax reassessment of the fund or of the SPVs from diminishing the IRR, making it attractive for investors at the time of fund establishment or for ongoing distributions.

There can therefore be substantial value and a direct impact on the IRR even when the insured risk does not materialize. Tax Insurance provides GPs with a valuable solution, where the fund can be liquidated to avoid any ongoing overhead costs whilst providing protection from long-tail tax risks. If the fund were to remain open, the overheads could be burdensome, and reserving the cash necessary to cover the potential risk would have a direct impact on the IRR. Tax Insurance can act as a tool to accelerate liquidation, keeping timelines tight to help funds achieve their IRR threshold return in volatile markets and returning capital to the investors while limiting ongoing overheads.

The same holds true for cash repatriation, especially through the payment of dividends. Frequently, when the payment is made between entities of two different jurisdictions, the withholding tax may be reduced by the tax treaties and/or the applicable European Directive. Since the European Court of Justice issued its ruling in the Danish Cases regarding beneficial ownership, tax authorities are permitted to override a tax treaty or the applicable Directive if substance conditions are not being met and holding companies across the region are being assessed with increased scrutiny. In conducting cross-border transactions, GPs are faced with several decisions: to pay the tax, to withhold the funds for several years in case of a dispute, or to protect funds through insurance. Obviously, the latter is an efficient way to satisfy the investors.

So Tax Insurance can cover a wide variety of tax risks, facilitates the negotiation of the transaction or allows for a quicker and safer repatriation of the funds to the investor. But for that to happen, it needs to be quick and the pricing will of course be a factor. Can you give us some details on these elements?

Pricing has significantly gone down over the past 24 months. We now regularly observe risks quoted by insurers (sometimes significantly) below 2%. Noting that risks under litigation (which are also insurable) would be placed at higher rates.

As for timing, it varies and depends on the complexity of the deal, or of the ongoing negotiations, but a policy can be put in place within three to four weeks.

By way of conclusion, what would be the most noticeable trends in the Tax Insurance market that you would like to highlight?

Insurers' appetite continues to grow, both in terms of variety of the risks they will consider, and the amount of capital they can deploy to provide coverage. This keeps on driving a trend that we have been observing for some time now, i.e. the decrease in the cost of Tax Insurance. We have also seen an increased appetite amongst some insurers to cover slightly riskier issues – for instance tax situations which are already under audit or have been adversely assessed.

Another interesting trend is the evolution towards more forward-looking risks. In the early days of the market, nearly all the risks insured were "historic". Now we see a significant number of so-called "forward-looking" tax policies, where taxpayers would seek to cover the treatment of events which have not yet occurred – a future sale, cross border distributions in the frame of the cash repatriation, or restructuring, for instance. Clients use Tax Insurance as a substitute or supplement to a traditional tax authority clearance or ruling – getting the certainty of treatment that they need, but from the insurance market rather than from an unpredictable tax authority.