Arthur J. Gallagher

WEBINAR TRANSCRIPT

TAX INSURANCE IN THE REAL ESTATE SECTOR

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PRESENTERS

NEON

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Focus of Webinar:

[AP] The purpose of this podcast is to explain what Tax insurance is and the role Tax Insurance can and cannot play within Real Estate Mergers, Acquisitions, Re-organisations and restructuring.

At Gallagher we are seeing a rise in debates involving the use of insurance in transferring certain tax risks from the client to insurers where these defined tax risks fall out-side the clients' tolerance or appetite.

Specifically, we are seeing a significant rise in the use of insurance in the Real Estate environment to insure both a) "defined but unaware risks" as well as "defined but known risks".

My colleagues Matthew Bates and George Minoprio have articulated in a three part Webinar the role Warranty and Indemnity insurance plays in "defined contractual but unaware risk" and for clarity here:

Warranty and Indemnity insurance looks to insure the defined contractual risks in the SPA and Tax Deed or Covenant - essentially defined risks which could arise, but to the best knowledge and belief of the Insured have not arisen at the time of the insurance placement; compared to the focus of this Webinar, "Tax insurance" which can insure risks which:

a) are contractual within the SPA / Tax Deed or Covenant and where the Client or Advisor has highlighted a known situation or risk (e.g. residency risk when acquiring an off-shore target), or

b) could rise through a re-structuring or reorganisation.

Generally we see Tax risks be insurable if they are low probability but medium to high severity; marketed tax avoidance schemes tend not to be insurable.

We have also seen the court's opining on an ever growing number of cases as tax authorities become more litigious and the increased perception around perceived tax non-payment which makes businesses increasingly concerned about tax risk.

(i) Residence & (ii) Trading Risk vs Investment

[DB] We have also seen a significant increase in the use of tax insurance in recent years. Robert Brown, who heads our M&A team at Neon, was the first of the London M&A markets to recruit a tax specialist owing to the increased demand for the product. I joined Robert's team in 2013 and have seen tax insurance used not only for a great variety of identified tax risks but also by a multitude of different persons from individuals to pension funds, private equity and sovereign wealth funds. The Real Estate sector have utilised tax insurance to great effect to minimise tax risk within their structures. This is becoming more and more relevant given the focus placed on offshore Real Estate structures by the Chancellor in his Budget. We have also seen demand, for tax insurance rise in the M&A situation, as a result of greater scrutiny and enforcement by the UK and other tax authorities. At Neon, we have insured a number of risks which particularly affect the Real Estate and Renewable Energy sectors but there are two main areas where funds and other entities approach us to seek insurance and these are:

Residence – it is usually difficult to find examples of anyone having the "perfect" residence position and this can have catastrophic consequences for a buyer if they think, for instance, they are buying a Jersey resident company but after signing the deal later discover they have in fact inherited a UK tax resident company. Most buyers are entirely unprepared to accept this risk which will have been caused entirely by the seller's actions. Depending on who the seller is, the Buyer frequently wants to have insurance protection for residence risk especially as the liabilities involved can be very significant. We also have private equity and real estate funds wishing to lock in their own residence position to date so that they can make immediate and full distributions to investors without any provision for potential residence liabilities or risk of clawback.

The second area we see frequently is **Trading vs Investment Risk** – this is very topical and of course was subject to significant changes in the Budget. Sadly the Government hasn't released the draft legislation on these changes as yet, so it will be interesting to see its scope. We have insured trading vs investment risks at Neon for similar motivations to that of residence in that the consequences of being deemed to have traded in real estate rather than holding it as an investment are often severe in terms of quantum. Arguably trading has always been a stronger weapon in HMRC's armoury than residence and certainly expect it to be after the Budget changes are introduced in the coming weeks. Having said that, we will still continue to assist those who wish to "lock in" their trading vs investment position pre the Budget changes and will seek to assist those who wish to insure trading risk post implementation of the Budget. The test for trading has always been based on factors and case law and can therefore be difficult for taxpayers to be sure of their position. Given the potential tax liability if HMRC disagrees with the analysis of trading vs investment by a company and its advisers, many funds seek insurance to protect themselves in what is a difficult and will be increasingly difficult and uncertain area for taxpayers.

Premium Rates

[AP] With regard to Premium rates, whilst each case is specific, we are seeing the predominant distribution of rates ranging from 3% to 7% of the sum insured as a one off for the policy period i.e. 7 years, with higher rates for tax risks which have a greater degree of probability. What's your view on this and what factors would Neon take into account when setting its rate?

[DB] I agree with you on premium rates which vary depending on a multitude of factors, including the level and conclusions of the tax diligence, the extent to which the target has complied with residence protocols or the extent to which the facts point towards trading vs investment. We work with the insured and its advisors to understand the nature of the risk at an early stage and are used to queries from accountants in particular on whether a particular fact pattern may or may not be insurable. At Neon we are always happy to have an initial conversation and to give an idea of likely pricing before all the relevant underlying materials are available to us.

Difficulty in offering Tax Insurance

[AP] Insurance will not be the answer to all Tax risks. I mentioned earlier that the insurances we have delivered have been low probability but medium to high severity, but not exclusively so. In Neon's view what are the factors which would make it difficult to offer tax insurance?

[DB] We do not insure tax avoidance schemes such as those which are the subject of the DOTAs regime. We will also not insure tax risks which are already the subject of a tax authority challenge. We also only tend to insure risks in jurisdictions where the tax system is developed and there is a reliable court system for hearing tax disputes. There is such a wide variety of tax risks out there in the insurance market but I agree that many classified as low to medium risk by tax advisors are often insurable but it is always worth looking at the details rather than generalising. A primary motivation for insurance is not because the relevant company believes they have got the tax position wrong, more that it arises from the deal dynamic with a seller demanding a clean exit as a pre requisite of the deal and partly as a natural consequence of the complexity of our tax law. Buyers also like the protection of the policy being able to insure them against potential non-disclosure or even fraud of a seller. The financial covenant of an insurance policy is often stronger than that of the seller.

Scope of Cover

[AP] Once the risk to be insured has been determined, we move to the scope of the policy coverage. The policy would tend to insure the Award, Defence Costs, Interest Payments and Civil Penalties.

[DB] Yes I would agree with that and we generally work with you and the insured to calculate an appropriate level of cover for those additional items which can be so significant in the event of a tax authority challenge, such as interest and defence costs. At Neon we aim to pay out to the insured up front if needed to defend a challenge which is becoming frequently the case in most jurisdictions. That way the insured does not have to face a cash flow issue in the event of a tax authority dispute.

Capacity

[AP] With regard to Policy Limits and Retention / Excess available, we would tend to see capacity of over €300m for the "appropriate risk", with Retentions low at £50k to nil. Would you agree?

[DB] Yes, I would agree with you Alan. There is more significant capacity in the market for M&A risks, including tax risks. At Neon we can insure up to £50 million or currency equivalent per tax risk. We work with many Private Equity and Real Estate funds at Neon who use the policies as a deal facilitator, to enable prompt distributions to investors and to put them at a competitive advantage.

Buyer, Seller or Other Parties as the Insured

[AP] Can we address the issue of Buyer or Seller as the Insured?

[DB] On tax risks, we are happy to insure either Buyer or Seller but generally also name the target as that is the taxpaying company and usually where the tax liability would crystallise. We are also happy to name a liquidator on the policy given many funds buy the policy in advance of winding up the fund.

Underwriting Process

[AP] Gallagher clients – be that direct client, their lawyers, accountant or Deal Advisors would identify a specific or range of tax risks, which require further thought. We would then counsel the client into developing a Submission for insurers which looks at; a) defining the risk or risks, b) quantifying the range of possible outcomes for each risk, and attaching any Opinions or Notes from the Insured Advisors or Counsel as is required, always considering that, for an any Insurance contract governed by English Law and most others, the client is required to declare all material facts. This submission is then ready for broking to the appropriate insurers. How does the Underwriting process work at Neon?

[DB] A lot of our thought process is completed at the time of quoting because we only ever provide a quote for a risk where we feel we will be able to deliver an insurance policy for that issue. At Neon, our team is extremely experienced and we are often a trusted insurer for a particular fund or company because we understand the sometimes incredibly challenging timelines of transactions and work with that deal timing. We have underwritten tax risks in 48 hours where necessary to meet the deal deadline. Our underwriting process will be to prepare some questions for the insured and its tax advisers to enable us to better understand the risk and also to prepare a policy wording. We as a team of M&A and Tax specialists at Neon have full decision making authority for the risks we quote and are often praised for being commercially sensible, flexible and creative in our approach to risk. With our considerable experience and tax expertise, in-house, we are able to accurately assess the risk at an early stage of the quote process and provide reliable terms, giving our brokers and clients the confidence to involve us as a trusted deal partner.

Claims Process

[AP] A smooth claims process is key to any insurance solution. Gallagher's work with our clients and the insurers to grasp and plan the best approach to claims.

[DB] At Neon, we have a dedicated claims team and we as underwriters work with our claims team to handle claims. Management and payment of claims is an integral part of our service and is essential to attracting and retaining business. At Neon, it is usually one of the M&A underwriters who acknowledges receipt of a claim by email and works with the broker and insured to see if any immediate action is required in relation to a claim. We also usually use the insured's original advisors to assist in the claim for speed and convenience for the insured. Importantly, Neon is the leader of a consortium where we manage and settle claims on behalf of the other participating Lloyd's syndicates rather than the insured having to deal with multiple insurers on any given claim.

Conclusion

[AP] Tax insurance will not be right for all Real Estate risks, but tax insurance should be investigated to review its appropriateness for that defined risk or risks. Significant insurance capacity is available for the right risk from insurers that are dedicated to this area.

About Neon

Neon is a dynamic, global insurer operating in the specialist Lloyd's market, committed to offering innovative risk solutions and proactively creating bespoke coverage for its clients.

Neon is highly experienced in underwriting a diverse range of property, specialty, casualty and marine risks on a direct and reinsurance basis, as well as through delegated authorities. Neon is headquartered in Gracechurch Street, London, UK.

Neon is a member of Great American Insurance Group. The members of Great American Insurance Group are subsidiaries of American Financial Group, Inc. (NYSE:AFG) an insurance holding company, based in Cincinnati, Ohio with assets of approximately US$50 billion.

For more information, please visit **www.neonuw.com**, **@Neon_UW**, **https://www.linkedin.com/company/neonuw/**

About Arthur J. Gallagher

Founded in 1927, Arthur J. Gallagher & Co. has become one of the largest, most successful insurance broking and risk management companies in the world. With extraordinary reach internationally, our parent group employs over 20,000 people and provides services in more than 140 countries. Outside the US we are known as Arthur J. Gallagher and wherever there is an issue of risk, we're there for our clients. We are a business without barriers – working together to create solutions that drive value and competitive advantage for our clients. Our people, our depth of technical knowledge and our global reach will deliver unrivalled advice and coverage expertise.

WOULD YOU LIKE TO TALK?

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