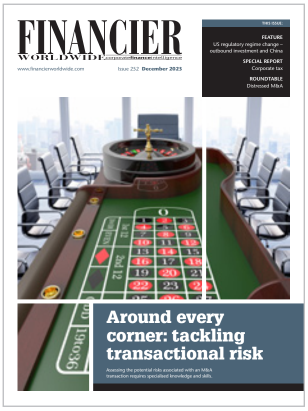

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Tax insurance in real estate

FW discusses tax insurance in real estate with Devorah I. Pomerantz at Great American Insurance Group.

Q&A:

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THE RESPONDENT

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Devorah I. Pomerantz is a divisional senior vice president with the mergers & acquisitions liability division at Great American Insurance Group. She has a JD and LLM in taxation from New York University School of Law where she was a member of the Law Review and The Order of the Coif. She began her tax law practice in 1995 at Davis Polk & Wardwell and has been underwriting tax insurance transactions since 2014.

FW: To what extent are you seeing an uptick in firms seeking to insure against unexpected tax liabilities arising from real estate? What factors are driving such enquiries?

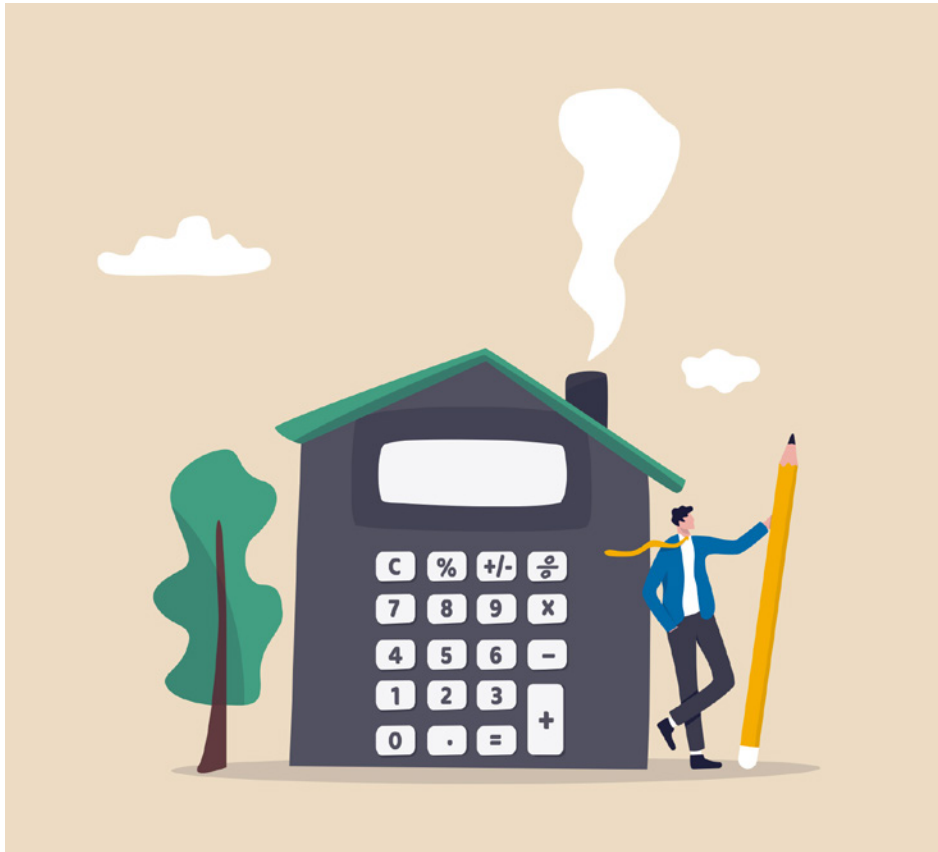
Pomerantz: In the past few years there has been increased awareness of tax insurance products. Tax attorneys and accountants are routinely recommending tax insurance to their clients as potential solutions to a variety of tax issues. This has led to the offering of more sophisticated tax insurance products, insuring a wider variety of tax issues. In addition, the number of insurance companies offering such products has increased dramatically over the last five years. This has brought about a healthy competition which has resulted in lower premiums, reduced deductibles and longer policy terms.

FW: Could you provide an overview of the key tax issues currently impacting the real estate sector? What risks do companies typically face in this area?

Pomerantz: The key real estate-related tax issues for insurers pertain to the US Real Estate Investment Trust (REIT) rules. In general, REITs are companies that own or finance income-producing real estate across a range of property sectors. These real estate companies must meet a number of requirements in order to qualify as REITs. REITs invest in most real estate property types, including apartment buildings, data centres, hotels, medical facilities, retail centres and warehouses. REITs are required to distribute at least 90 percent of their taxable income annually to shareholders as taxable dividends. REITs receive a dividends-paid deduction such that generally no tax is paid at the entity level if 100 percent of income is distributed. The determination of whether a particular REIT has met all the REIT qualifications is a key concern for potential investors. Therefore, they look to tax insurance as a method of providing certainty that they will not be subject to a large tax burden due to a REIT's failure to meet any one of the many rules that govern REITs. In addition to the REIT rules, there are a variety of deal-specific real estate tax issues that are candidates for tax insurance, including property tax, state and local transfer taxes, tax credits affecting certain specific real estate assets and tax rules relating to depreciation. In an acquisition setting, potential acquirers of a real estate company are often concerned about, and insure against, unknown preclosing tax liabilities relating to the acquired company.

FW: What situations may arise that are particularly suited to a tax insurance solution? What are the advantages of having robust tax insurance in place?

Pomerantz: The most common real estate-related situation that is particularly suited for tax insurance involves a purchase of a REIT or series of REITs. Often a sale will occur where the seller desires a clean break without putting any funds in escrow with respect to potential tax liabilities for failure to qualify as a REIT. Alternatively, the seller may agree to put a certain amount into escrow for a set period, but the buyer may desire a more robust indemnity for a longer term. In these situations, what is generally offered is a hybrid tax and representation and warranty product (R&W) that includes full R&W coverage, including coverage for representations relating to authorisation, title to property, compliance with laws, financial statements, material contracts and environmental matters, among others, as well as coverage for REIT qualification and preclosing taxes. The next most common situation is an insurance policy that relates to the prohibited transaction tax. In general, when a REIT holds real property primarily for sale to customers in the ordinary course of a trade or business, the REIT is subject to a 100 percent tax on the net income derived from a sale transaction. Whether a REIT is a dealer in property is based on all the facts and circumstances. Certain safe harbours apply. Often, when a particular REIT transaction does not qualify for a safe harbour, an insurer will insure against the possibility of the imposition of the 'prohibited transaction tax'. In addition to the REIT area, depending on the factual background, tax liabilities relating to state and local transfer tax, property taxes, depreciation recapture, capital versus ordinary income, and many other tax issues relating to real estate transactions can be insured.



FW: In general, are there any types of real estate-related tax risks that cannot be covered by a tax insurance policy?

Pomerantz: Submissions are reviewed on a case by case basis. However, many insurers will not insure certain risks relating to reportable transactions, risks with an opinion that is on a level lower than 'more likely than not', or issues that are under increased Internal Revenue Service (IRS) scrutiny. In addition, some insurers will not insure transactions under audit or in the litigation process. Generally, policy terms are seven to eight years but often can be no longer than 10 years. Consequently, risks that require a longer term, such as taxes relating to transactions that have not yet occurred or particular tax credits that are recognised over a long period, may not be fully covered by a tax insurance policy.

FW: Given the complexity of tax rules and property portfolios, how should companies and investors go about obtaining a tax insurance policy that provides peace of mind? What particular considerations need to be made to ensure an offering is fit for purpose?

Pomerantz: A highly rated insurance company experienced in the tax insurance market can be a key element in helping policyholders achieve peace of mind. Sophisticated tax underwriters with experience in the area of tax law relating to the insured risk gives rise to a smooth underwriting process. When an insurance underwriter has experience working with an insured's attorney, it can streamline the policy negotiation process. An insurance policy that is clear and easy to understand, with specific and narrow exclusions where required, provides the insured with a reliable and valuable product.

FW: To what extent are tax authority audits and disputes an increasing concern in relation to real estate holdings?

Pomerantz: The IRS is in the process of increasing its agents and audit activity. In addition, there are many large companies that are audited on a frequent or

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continuous basis. In addition, the IRS has become more sophisticated in identifying risks that are appropriate for an audit. On the state and local side, state and local taxing authorities will often audit large real estate transactions. The combination of these factors leads to appropriate concern by participants in the real estate industry as to the possibility of an audit and ultimately a large tax liability.

FW: What essential advice would you offer on managing real estate tax matters, gaining certainty on tax positions and transferring risk to the extent possible?

Pomerantz: The first order of business pertaining to real estate related tax insurance is to understand whether the particular risk is insurable. Early involvement of a specialist broker who can assist in the structure of the insurance programme is invaluable. Once it is determined that a risk is insurable, clear and concise presentation of the risk to the insurance markets can favourably impact both the willingness to insure and the cost of coverage. In addition, underlying professional support, such as a tax opinion, tax memo or due diligence report, while potentially costly, can lead to enormous reductions in policy premiums. Once the underwriting process is underway, transparency and flexibility on the part of the client, the broker and the underwriter, as well as a willingness to 'think out of the box' where appropriate, are necessary components of a successful risk transfer. ■

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