Post - Boardwalk Hall, Think Tax Insurance

By Gary P. Blitz, Aon Tax and Transactional Risks

Although the recent Historic Boardwalk Hall (HBH) case has become a significant focus for the tax credit industry on what is an acceptable guaranty of a tax credit investment, there remains a class of tax credit investor that seeks protection against the failure of projected tax benefits to materialize. Tax insurance has provided protection to tax credit investors since its advent in the 1980s and today offers a customizable solution that can provide the protection tax credit investors seek while paying homage to the tax law principles espoused by the 3rd Circuit Court in the HBH case.

Tax insurance supports tax credit investments across the board, including those involving low-income housing tax credits (LIHTCs), solar investment tax credits (ITCs), new markets tax credits (NMTCs), historic tax credits (HTCs) and so on. A properly structured insurance program remains an option for tax credit investors seeking assurance that their investments will pass muster of the tax authorities and will live up to projections of anticipated tax benefits. The HBH case and other recent authority should be viewed as a reminder that tax insurance can be used effectively to protect tax credit investments while preserving the pass through nature of a partnership or limited liability company (LLC) investment vehicle.

Understanding Tax Insurance
At the outset, it's important to define “tax insurance,” as insurers and non-insurers have provided many types of instruments to the tax credit industry. Tax insurance was first developed in the 1980s in the context of the transfer of investment tax credits (allowed through 1986) through the safe harbor lease or tax benefit transfer, a congressionally authorized paper transaction that changed the ownership of the underlying equipment for federal income tax purposes only. This essentially was a statutory predecessor to the partnership/LLC transactions that are done today. The tax insurance supported a tax indemnity that the tax credit seller (aka the lessee), provided to the tax credit purchaser (aka the lessor). This tax insurance program was highly successful for the insurance company involved, which was the originator of many of today’s tax and merger & acquisition (M&A) insurance products.

Tax insurance is protection provided in the form of an insurance policy by a property and casualty insurer. Tax insurance can be distinguished from balance sheet guarantees, financial guarantees, swaps, letters of credit, etc., even if provided on an insurer's balance sheet. While the goal of many of these instruments is similar – to protect the tax credit investor against the insured peril – tax insurance will be written for a defined period of time for a stated limit of liability and will provide the enumerated protection upon the occurrence of the insured event (e.g., failure to qualify for a solar ITC and/or recapture of such tax benefits), provided the insured files a timely claim with the insurer. Typically, in the event the policy is triggered, loss will equal tax, interest, penalties, contest costs and a gross up on already

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claimed benefits, as well as lost promised future benefits. It’s also important to note that the tax insurers expect a well-structured underlying transaction with the sponsor guarantees and reserves that are typically found in tax credit transactions.

Tax insurance can be written in a broad “all risk” fashion to cover the qualification and recapture risks a tax credit investor will face over part or all of a tax credit investment’s life. It also can be structured in a manner limited to particular risks. For example, a tax insurance policy can cover only a structural risk, such as a partnership being respected as such or, borrowing an example from a not too distant asset class, that a real estate investment trust (REIT) is a valid REIT. Insurers consider this “tax opinion insurance” because it essentially covers the risk that the tax advisors opined correctly on the tax treatment of the transaction structure (although an actual opinion is not required to obtain the insurance). The insurance market can address a specific tax opinion risk or provide a broader policy more equivalent in scope to what many guaranteed investors have traditionally sought. Of course, even in the broad guarantees, the investor market has accepted the exclusion of certain types of loss, such as change in law, the investor’s inability to use the tax benefits and terrorism.

### Examples of Tax Insurance

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### Insurance and Guarantees May Not Be Interchangeable

There is a school of thought that tax insurance may offer a more preferable means to obtain protection than many of the previously utilized forms of guarantees. Clearly, HBH has raised issues with a level of guaranty so extreme as to leave an investor without any upside or downside. Tax insurance offers the ability to customize a structure that incorporates HBH’s teachings while leaving the investor substantial protection. Indeed, in the related context of a

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partnership flip structure utilized for a wind farm that qualifies for production tax credits, Internal Revenue Service (IRS) Revenue Procedure (Rev. Proc.) 2007-65 distinguished between guarantees provided by the sponsor or another party to the transaction and protection purchased by the investor from a third party, such as an insurer, the latter being referred to as “an acceptable guarantee.” This suggests that tax insurance independently obtained and paid for by the tax credit investor has a favorable status compared to a built-in guaranty.

**Tax Insurance Can Match Investor Objectives and Scope of Coverage**

A “one-size-fits-all” approach is not the best option, considering that different investors seek different degrees of protection. Consider the varying approaches LIHTC investors bring to the table. Some investors may seek tax insurance or a guarantee to qualify for the effective yield method (EYM) of accounting, but may not be particularly concerned about the performance of the underlying LIHTC projects. Such an investor requires a limit of liability equal to more than its capital contribution. This investor could achieve its objective (i.e., EYM accounting) and benefit from significant cost savings by purchasing a shorter-term policy and renewing it periodically. Some EYM investors also have been able to reduce cost by accepting limitations on coverage triggers as opposed to an “all risk” approach to coverage. Other investors may seek to manage the risk of the LIHTC project performance but have little concern about the accounting treatment. It would be prudent for that investor to approach the tax insurance program with lower limits than the EYM investor would. After all, the likelihood of all projects in a fund failing is extremely remote. That investor would be well protected by a limit sufficient to cover a recapture event at all of the projects. Such an investor might also consider the cost savings of a “return of capital” versus a traditional “yield” protection and incorporating a shorter initial term (less than 17 years) that can be renewed. Similar logic might apply for a solar ITC investor in a fund of thousands of small installations. Does such an investor really need to pay for coverage limits sufficient to protect against all equipment simultaneously falling out of compliance? Keep in mind that every premium dollar saved by narrowing the protection has the benefit of increasing the investor’s yield and is likely to buttress the strength of the HBH analysis.

The tax insurance discussed in this article has a wide ranging potential to protect tax credit investors as to the full spectrum of issues that may get in the way of a tax credit investment performing or more narrow issues that could prevent their willingness to consider an otherwise comfortable investment opportunity. Readers are encouraged to consider customized protection to suit their needs as an alternative to traditional broad forms of guaranty in the post-HBH world.

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Gary P. Blitz is managing director in insurance broker Aon’s Tax and Transactional Risks practice. Gary splits his time between the New York City and Washington, D.C. offices. Gary is an internationally recognized expert in the insurance of financial and transactional risks. He joined Aon after a 20-year legal career, during which time he acted as legal counsel to U.S., London and international insurers and was involved with the development of today’s tax and M&A insurance products. Gary also is a founder of Kingswood Group, a tax credit insurance underwriter. Gary’s articles have appeared in numerous publications, and he regularly speaks on subjects related to his practice. Gary can be reached at gary.blitz@aon.com or 212-441-1106/202-429-8503.