Realizing Certainty through Tax Insurance

Empower Results®

Bring Certainty to Tax Exposures

Today's tax structures and their legal, financial, and business implications have grown rapidly in both size and complexity. Tax insurance is designed to protect you in the event that a transaction fails to qualify for its intended tax treatment.

Introduction

Aon's Tax Insurance team delivers unparalleled depth of knowledge and experience to effectively guide clients in protecting against an adverse tax ruling that can compromise the value of a transaction, a tax equity position, or earnings. Our broad range of tax insurance solutions addresses many tax risks that deal professionals, corporate tax professionals, and tax credit investors face.

When working with Aon, our clients are confident that their investments are secure and certainty for their tax positions is realized.

Aon's tax insurance and M&A insurance solutions include

- Representations and Warranties Insurance
- Tax Insurance
- Tax Credit Insurance
- Litigation Insurance
- Bespoke Contingent Risk Solutions

Protect against Unexpected Tax Liabilities

Today's tax structures and their legal, financial, and business implications are material and complex. The impact of an unexpected tax challenge can significantly compromise the value of a deal, a tax credit investment, or tax planning.

Tax insurance is designed to protect you in the event that an investment or tax position fails to qualify for its intended tax treatment. This can cover losses including taxes payable, interest and penalties, and gross-up amounts for tax due on insurance proceeds. It can also cover contest costs tied to the defense of the insured position.

Similar in effect to a private letter ruling, tax insurance brings certainty to taxpayers regarding the treatment of their U.S. federal, state, local, and foreign tax positions.

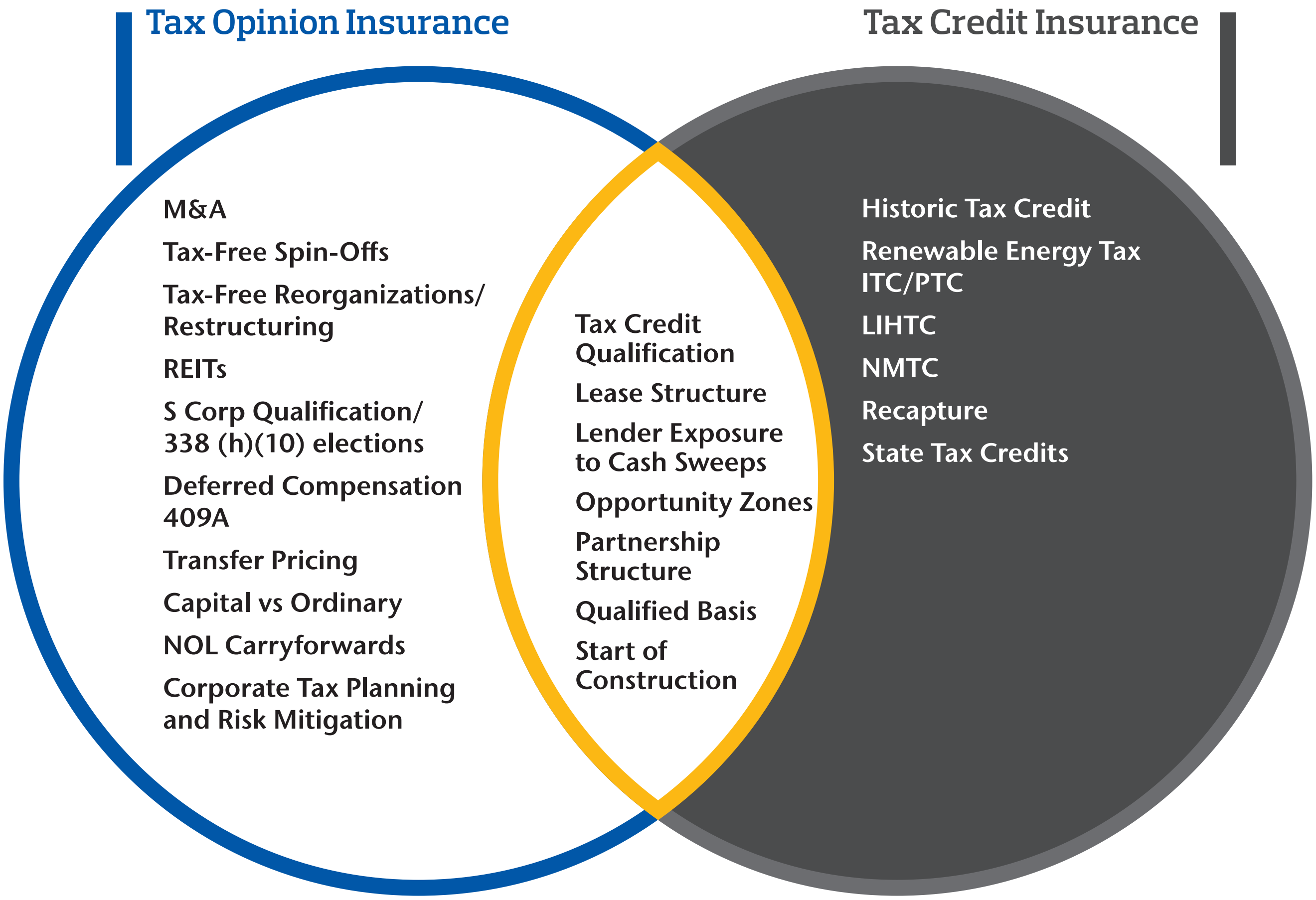
Tax insurance is an effective and economic means of protecting against an unexpected or significant impact on financial statements and earnings. Aon clients that have relied upon tax insurance include private equity sponsors and their portfolio companies, Fortune 500 companies, and other participants in global M&A and financial transactions.

With tax insurance, organizations can

- Achieve certainty absent a private letter ruling from the IRS
- Efficiently allocate the economic risk of a tax loss
- Avoid or reverse the financial statement impact of FIN 48 reserves
- Mitigate counterparty credit risk in tax indemnity agreements
- Address the small probability of significant loss
- Replace or reduce escrow required by a seller
- Extend or add to the survival of the seller's escrow and indemnity for a buyer's benefit

Our clients are secure that they have greater certainty when facing tax risks.

Examples of Insured Risks



Impact of Tax Reform

Today’s tax environment can bring a great deal of uncertainty as taxpayers evaluate existing tax positions and future tax planning. The impact of the Tax Cuts and Jobs Act, the majority of which went into effect as of January 1, 2018, remains to be seen. The unprecedented speed with which the new rules went through Congress has left both tax practitioners and taxpayers scrambling, and it is unclear whether corrective legislation is still forthcoming.

An unexpected adverse tax ruling can result in a failed transaction or a loss of anticipated tax benefits. To protect against these risks, clients have been leveraging tax insurance in increasing numbers. To help shield our clients from unanticipated tax consequences, the tax insurance team at Aon offers guidance and solutions tailored to each unique situation. The policies have become more cost-effective with time, due to both the competitive market and lower combined federal and state and local rates. In this context and others, tax insurance remains an extremely effective means to achieve certainty for material tax issues in transactions, in tax planning, and where traditional opinions are rife with caveats and private letter rulings are not a practical option.

Improve Outcomes for M&A Deals and Other Transactions

A large tax exposure can present a difficult or even insurmountable obstacle in a deal negotiation, particularly if it will take many years to resolve. Tax insurance can be used to provide certainty and allow a buyer and seller to move past a difficult negotiation over an uncertain issue and close a deal. As a strategic financial tool, tax insurance assists a seller looking to backstop its indemnity obligation for pre-close tax exposures, or allows a buyer to insure itself against a sensitive tax issue rather than seek a special indemnity that can hinder the deal.

In a transaction, tax insurance complements representations and warranties insurance, which protects against unknown breaches of the tax representations and the pre-closing tax indemnity. Where a material, known tax risk has been identified that results in an exclusion to representations and warranties coverage, tax insurance is an accepted means to transfer that risk away from the buyer and seller.

Strengthen Business Tax Risk Management

Businesses can benefit from the strategic use of tax insurance to manage their contingent tax exposures even when there is no transaction involved. The insurance market has matured and with it our insurers' willingness to entertain tax risks without a transaction – allowing tax insurance to be used as simply a corporate risk management tool.

Tax insurance can be viewed as an alternative to a private letter ruling, protecting a company from exposure from future challenges from the IRS or another foreign, state, or local tax authority. While private letter rulings are often unavailable or prohibitively time consuming, tax insurance can provide an efficient and cost-effective option. A process that can take a year or more is streamlined into two or three weeks of underwriting, while still providing economic certainty as to a company's tax positions and mitigating balance sheet risk. With its expanded use, the accounting treatment for tax insurance also has become clearer. Aon has been advised by a Big Four firm that tax insurance can be a means to mitigate the financial statement impact of pre-existing or a foreign, state FIN 48 reserves.

In this regard, by incorporating tax insurance into a company's strategy, what might have had a negative P&L and balance sheet impact can be viewed as P&L and balance sheet positive.

Tax insurance can bring certainty to a variety of tax equity investments

Secure Tax Equity Investments

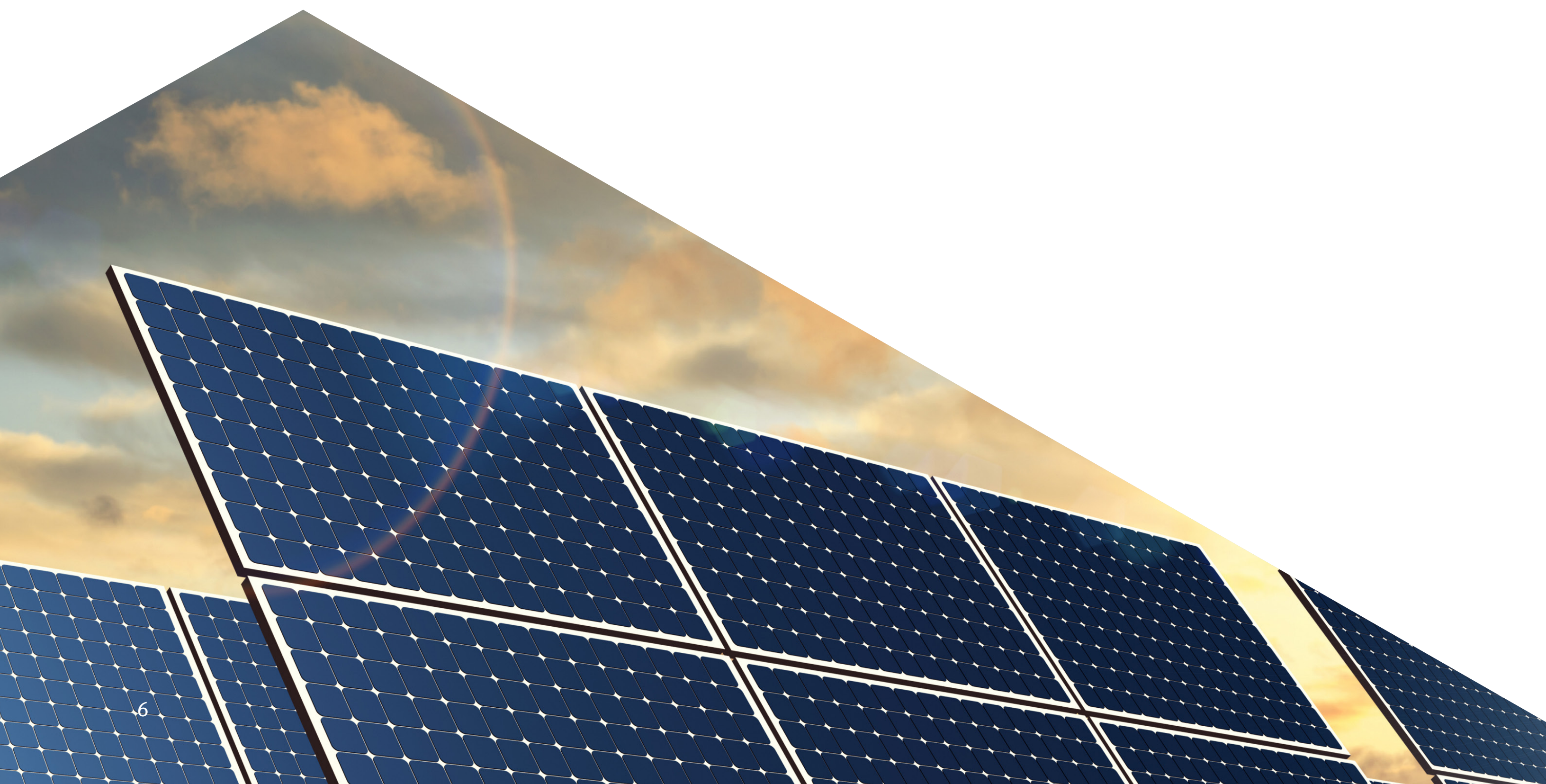
Tax credits are a staple in the federal and state government's toolbox to encourage a variety of social or environmental investments. For tax equity investors, a key incentive to investing in these projects is to monetize the associated tax credits, which in turn provides a source of funding for the development of the projects.

Because tax equity investors are passive parties to the investment, they are subject to a number of tax risks, including

- The investment structure not being respected
- The transaction not qualifying for the projected tax benefits/credits
- The loss of tax benefits through recapture

Tax insurance helps manage these risks and was identified by the IRS in Rev. Proc. 2014-12 as a preferred vehicle over guarantees by transaction parties.

Tax equity investors can also secure coverage to protect against retroactive change in law and nonperformance by state and local governments with respect to refundable tax credits.



Renewable Energy – Solar, Wind, and Other Technologies

The federal government and several states provide an investment tax credit for a percentage of the cost of various types of renewable energy projects, most notably solar and wind. The federal investment tax credit is now available at current rates through 2021.

Tax insurance can protect tax equity investors in the event that the investment structure and allocations are not respected, the investor does not qualify for the projected credits, or tax credits are recaptured during the five-year recapture period.

The marketplace has developed since 2013, when Aon placed a tax insurance program on behalf of a major solar developer and tax equity investor. Today, Aon's policies have better terms and conditions and better economics than these vintage programs. In addition, it has become common for transactions in which lenders are exposed to cash sweeps securing the tax indemnity of the developer or sponsor to use tax insurance to protect them from interruption in the debt service.

Historic Rehabilitation Tax Credit Insurance

Today, the Internal Revenue Code provides for a five-year credit against tax for qualified expenditures of specified historic structures in the year a rehabilitated building that meets Department of Interior standards is placed in service. For these investments, insurance can protect against the impact of a loss of the historic structure as well as loss or interruption of the credits due to the investor's failure to qualify or to future intervening events that take the project out of service, formerly referred to as "recapture events."

Affordable Housing

The Internal Revenue Code provides a 10-year stream of low-income housing (LIHTC) tax credits for building affordable housing with the purpose of renting to qualified tenants. Failure to operate the project in compliance with the tax rules can result in the recapture of credits. Tax insurance can be used to help protect institutional investors investing in funds owning these projects. In addition, tax insurance has been used to protect against the failure of the IRS to respect specified tax treatments in credit transactions.

New Markets Tax Credits

The Internal Revenue Code authorizes a 39 percent tax credit for many types of investments in low-income communities, ranging from housing to commercial enterprises. This tax credit is earned over seven years and is subject to recapture under specified circumstances. Insurance can be used to protect against specified events of recapture.

Tax Insurance Solutions in Action
Case Studies

Public Merger – Exit and BEAT Taxes

Our client, a Fortune 500 U.S. public company, merged with a large business unit of a FTSE 100 U.K. public company. For various business reasons, the parent entity of the new $11 billion combined company is based in the U.K. The client received a tax opinion from a Big Four accounting firm that the merger is not an abusive corporate inversion designed to avoid paying U.S. corporate tax rates. The potential exit tax and Base Erosion Minimum Tax (BEAT) liability was approximately $650 million. Due to the magnitude of the risk, the client desired tax insurance to protect against a successful IRS challenge.

To bring certainty to this deal, Aon was able to structure and secure the largest tax insurance policy ever placed, with a $750 million limit and seven-year period. The tax policy covered any challenge by the IRS or state that the client's transaction triggered the U.S. anti-inversion tax laws. The tax policy covered (a) potential U.S. federal and state income taxes, plus interest and penalties following a successful challenge by the IRS or state, (b) contest costs, and (c) a gross-up (up to the $750 million limit) for the tax on any proceeds received by the client under the Tax Policy with only a minimal retention applicable to contest costs.

Policy Development under a Tight Deadline

A non-U.S. company sought to purchase the shares of a U.S. manufacturing corporation from a private equity seller. The buyer company's due diligence revealed that a prior restructuring transaction might be taxable under complex consolidated return regulations. This was unexpected because the private equity firm had received a legal opinion that it should be a tax-free transaction. However, that opinion was based on assumptions about events that ultimately did not occur. The private equity firm refused to provide the company with full tax indemnity. The company had ten days remaining in its exclusive period (including the Christmas holiday), and the private equity firm was unwilling to extend the time period.

A tax insurance policy was placed to insure the tax liability risk as a result of the restructuring not being treated as a tax-free transaction. The buyer company was the insured. The tax insurance policy had a $50 million limit, and a seven-year period. The one-time premium today would be $2.5 million. The tax insurance policy was bound within the ten days remaining on the exclusive period, and the sale and purchase agreement (SPA) was executed. The deal closed several weeks later.

Excluded Tax Risk under a Representations and Warranties Policy – S Corporation Validity

Aon's client, a private equity buyer, purchased a U.S. retail business that was family-owned and operated since the 1950s, comprising four entities qualifying as S corporations. Although the seller's Big Four tax advisors provided a tax advice that the S corporations were valid, the buyer and its Big Four advisor felt it was not sufficiently conservative. The representations and warranties policy purchased by the buyer at closing excluded coverage for tax losses associated with the S corporation issues, which included potential second-class-of-stock issues.

Aon was able to help its client by structuring and securing a $100 million tax insurance program with "A" rated or better insurers, which protected the buyer against an adverse resolution of the S corporation issues. The tax insurance program had a $100 million limit of liability and a $500,000 self-insured retention with a policy term of six years. In the event of a successful IRS challenge, the insurers would pay the additional federal and state income taxes, plus interest and penalties.

Notable Recent Tax Insurance Transactions

- Protection of tax equity investors in renewable energy projects (solar and wind) qualifying for federal and state tax credits against failure of the transaction structure to be respected, failure to qualify for the tax credit, and recapture
- A $400 million policy insuring that a multinational corporate reorganization did not trigger FIRPTA tax
- A policy bound after a formal challenge from the IRS – a $75 million program for a client's worthless stock deduction
- $350 million portfolio program protecting debt investors in securitizations of residential solar receivables against the interruption of the cash flow following a successful challenge to the qualified basis of the solar equipment in 20 funds

- A large policy for a Fortune 500 multinational managing the risk that the IRS will disagree with its methodology for sourcing foreign losses to the U.S.
- Tax insurance programs for purchasers of private REITs against failure of the target entity to qualify as a REIT
- Mexican transfer pricing risk that a buyer became exposed to in an M&A transaction
- $100 million policy covering the buyer that NOL carryforwards will offset taxes due on pre-closing restructuring and any other undisclosed pre-closing tax liabilities
- $150 million program covering the buyer of highly appreciated energy property, with potential historical exposure if earlier valuations were successfully challenged by the IRS

Sale of a Private Real Estate Investment Trust (REIT)

In recent years, a popular investment strategy has been to hold real estate through a single-purpose REIT. However, as the owners of such properties consider their exit, they come to realize that buyers are discounting the purchase price if they buy the REIT entity rather than the property itself. In addition, the seller typically is required to provide representations and warranties and a multi-year indemnity regarding REIT qualification under relevant tax rules, making REITs particularly unattractive to PE sellers looking to return capital to investors soon after the sale of a property.

A hybrid tax and representations and warranties insurance product will assume the risk of REIT disqualification during the seller's period of ownership. Further, the seller will be allowed to conclude the transaction without the survival of its representations and warranties relating to the tax treatment of the REIT as well as the business. This coverage can be implemented on a single-transaction or programmatic basis. This use of tax insurance has continued to evolve. In a recent transaction involving the sale of a limited partner's interest, coverage was provided to the buyer even though it had no right to participate in the tax contest and unique go-forward coverage also was obtained by Aon.

Solar Investment Tax Credit (ITC) Fund

A technology company sought to invest in a fund sponsored by a solar energy company that would, in turn, invest in a portfolio of residential and commercial projects. Because the investment was outside its core business, the technology company required assurance that the projected tax benefits would be received and not lost due to a recapture event. Tax insurance was used to assure the investor that the investment vehicle would be respected as a pass-through entity, that the solar facilities would indeed qualify for the credit and the tax basis would be respected, and that there would not be a tax loss due to recapture. The tax insurance policy had a $50 million limit equal to the amount of projected tax benefits and provides coverage for additional taxes, interest, and penalties for a disallowance or recapture that runs through the end of the recapture period.

"Aon team – while we're waiting for last Ts to be crossed on the merger agreement, I wanted to thank you for your excellent and tireless work and your leadership with the insurers. The [transaction] we are about to sign most definitely would not have happened without this highly bespoke insurance. Great job, greatly appreciated by both law firms and both clients."

– M&A Partner at Major Law Firm

"We have been recommending the Aon Transaction Solutions team to our clients needing tax insurance for over 10 years. We have closed deals that simply would not have happened without tax insurance.

The creativity, professionalism, and technical abilities of Aon were critical to achieving the transfer of the tax risk to the insurers."

– Tax Partner at Major NY Law Firm

"I wanted to briefly let you know how much we appreciate all of your work on our transaction. The tax policy ended up being a challenging but essential piece of the puzzle that I truly believe was the bridge over the value gap between the buyers and sellers.

Although tax is clearly not our strong suit, your guidance through the process made binding achievable and for that we are grateful.

Thanks and look forward to working with the Aon team on future transactions."

– Vice President at Midstream Energy Company

The Aon Advantage: Delivering a Long-Standing, Proven Approach

Tax insurance is a solution with a long and successful history. It has been written by the insurance markets for Fortune 500, private equity, and middle market companies since the early 1980s, when Lloyd's of London covered investors in lease transactions against loss of projected tax benefits.

Aon was among the first to participate in this specialty market and we have worked closely with our clients to manage a wide range of tax risks.

Comprising tax attorneys and tax accounting professionals, Aon brings a depth of knowledge and passion needed to develop tailored solutions to your complex tax risks. We offer experienced guidance to help ensure that your investments are secured and that value is enhanced.

Since 2013, Aon's U.S. tax practice has placed hundreds of policies representing over **$13 billion**, including several large programs over **$500 million**. As more "A" rated or better insurers have entered the market, the insurance capacity has grown to be an estimated $1.5 billion per risk.

Aon's Transaction Solutions team has the largest and only dedicated tax team in North America with 6 former tax lawyers, and an expanding tax team globally.

To Learn More:

Aon professionals can provide your organization with the experience, tools, and deep industry expertise required to maintain a competitive edge in today's markets. Contact the following representatives to learn more about specialized solutions from Aon's Transaction Solutions Practice.

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With deep global tax insurance experience and in-country support in the Americas, EMEA and APAC, Aon helps clients realize certainty in jurisdictions around the world. The members of the America's tax team are pleased to make introduction to our global colleagues.

About Aon

Aon plc (NYSE:AON) is a leading global professional services firm providing a broad range of risk, retirement and health solutions. Our 50,000 colleagues in 120 countries empower results for clients by using proprietary data and analytics to deliver insights that reduce volatility and improve performance.

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