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How to eliminate tax risks in real estate transactions using insurance

Real estate investment in APAC took a serious hit during the pandemic; however, there are signs of recovery in 2023, with Japan, Korea, Singapore, and Australia expected to be the most active markets.[1] When negotiating transactions, buyers and sellers have to navigate tax risks related to the target assets/shares or the transaction structure. Due Diligence and expert tax advice can help alleviate some level of risk; however, there always remain areas where risks cannot be ruled out completely. To protect against unforeseen financial losses, deal parties are increasingly turning to tax insurance as BMS Group's Martijn de Lange and Faith Swee explain in this note.

What is tax insurance?

Tax insurance was established over 20 years ago to meet market demand for an effective transfer of tax risks from taxpayers to the insurance market. Under a tax insurance policy, the insurer takes over an identified risk of 'loss' (consisting of tax, interest, penalties and defence costs) arising from a successful challenge by a tax authority to the expected tax treatment of a current, proposed, or historic transaction. This way, the taxpayer can completely remove the potential financial exposure from its balance sheet.

A tax insurance policy provides cover for a period of 7 to 10 years from the policy inception date. The premium is one-time-only and a percentage of the insured amount. For real estate related tax risks in APAC, premiums range between 1% and 3%, depending on (i) strength of the tax position; (ii) financial exposure and (iii) insured's tax dispute history.

Tax insurance is mostly used in transactions as deal parties' views and objectives typically conflict when it comes to negotiating the allocation of tax risks. In general, buyers don't want to assume the target's historical tax exposures whilst sellers don't want post-completion liabilities ('clean exit'). Tax insurance can help bridge the gap between deal parties as Adam Singer, Tax Insurance Director with Certa Insurance Partners, notes:

> *"Our experience is that advisers and deal makers find tax insurance to be a great deal facilitation tool in their toolbox. Countless buyers and sellers have benefitted from streamlining their negotiations by removing a potentially contentious issue from discussions. Certa has insured tax risks across APAC, particularly in the real estate sector. Awareness of the tax insurance product is growing and this is evidenced by significant year on year growth in submissions from APAC jurisdictions."*

Let's look at three examples of common tax risks in real estate transactions in APAC and how insurance can help achieve a more efficient outcome for deal parties.

Example 1: Revenue versus capital

In Hong Kong, Malaysia and Singapore there is much uncertainty regarding the qualification of a divestment gain as 'capital' or 'revenue' in nature. If it's the former, the gain is exempt. If it's the latter, the gain is taxable. When local tax authorities assess the qualification of a divestment gain, they review the totality of facts and circumstances of the case against a set of factors established under case law ('badges of trade'). Among those factors are the taxpayer's motive or intention

[1] See for instance: Colliers 2023 Global Investor Outlook: Asia Pacific Highlights.

when acquiring the asset and the length of ownership.[2] Since the factors are not clear cut it is rare that a taxpayer 'ticks all boxes' and tax authorities often challenge tax positions.

Having assisted numerous investors on Singapore real estate investments, Wee Hwee Teo, Partner, Head of Real Estate, Tax and Head of Asset Management & Family Office with KPMG, notes that the differing exit tax consequences depend on the mode of divestment and the domicile of the relevant shareholders:

> *"Where the exit is in the form of an asset sale, the Singapore tax authorities (**IRAS**) must be convinced that the property has been acquired for long-term investment purposes, therefore subjecting taxpayers to lengthy questioning and protracted correspondences. Often, uncertainty in tax outcomes leads to the provision of contingent tax liabilities, hampering the ability to repatriate cash to investors promptly and most certainly affecting the fund manager's carried interest. Achieving certainty through an advance ruling is becoming a rarity nowadays as the process is too time-consuming, with some cases dragging up to over a year, rendering this 'traditional' option not feasible from a commercial perspective. Needless to say, securing a tax policy becomes the obvious solution.*
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> *Where the exit is effected via the sale of shares in the property (intermediate) holding company and where the shareholder(s) are Singapore tax resident persons, there tends to be less scrutiny as long as one can satisfy certain conditions under the Singapore's version of the participation exemption, also known as the 'safe harbour rule'. However, there are still cases with grey areas or tax avoidance concerns such as those associated with the sale of an intermediary holding company. In these cases, securing a tax policy would be a prudent solution to remove uncertainties in transactions."*
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> *In case said shares are being sold by an offshore shareholder, Singapore's semi-territorial basis of taxation normally ensures that the divestment gain does not fall within the Singapore tax web. Practically, challenges from the IRAS are rare. Nonetheless, a tax insurance policy could still be extremely useful where the foreign seller happens to be an offshore fund managed or advised by a Singapore based fund manager, thus potentially bringing the gain to be within the Singapore tax web."*

Example 2: Tax treaty benefits

Real estate investment structures are often complex. Aside from legal, commercial, or regulatory considerations, tax treaty benefits may be an important factor when setting up the structure. Examples are reduced withholding tax rates or capital gains tax exemptions.

In practice, tax authorities may refuse to grant treaty benefits if they consider an investment structure to be purely 'tax-driven'. They could challenge the 'beneficial ownership' status of an income recipient by arguing that the recipient has no right to use and enjoy the income.[3] This is a subjective assessment which involves numerous factors, such as the income recipient's economic substance and the overall commercial rationale of the investment structure.

Some tax authorities in APAC are known to take aggressive positions when it comes to beneficial ownership. Take for example Korea, where many (foreign) investors are getting challenged by the Korean tax authorities. Maria Chang, Senior Foreign Attorney in Tax Practice Group at Korean law firm Bae, Kim & Lee LLC, notes that:

> *"Due to the highly fact-specific nature of beneficial ownership analysis and the intricacies involved in various structrues, tax authorities in Korea are inclined to challenge structures*

[2] Other factors are (i) the frequency of similar transactions; (ii) the subject matter of the transaction; (iii) supplementary work on the asset disposed of, (iv) the mode of financing, and (v) circumstances leading to and surrounding the disposal of the asset.

[3] The OECD considers a 'beneficial owner' to be the person 'who has the right to use and enjoy that income'. The said right is unfettered of any contractual or legal obligation to pass on the income to another person.

that are oftentimes unable to fully substantiate the chain of ownership in a particular investment. Post-transaction audits are common and may result in unexpected leakages several years after the transaction. In order to avoid such pitfalls, sellers are advised to prepare supporting documents in advance of a transaction to ensure that recipients of income will enjoy benefits of tax treaties. Buyers, on the other hand, should seek contractual indemnity to avoid potential liability."

Again, buyers and sellers can use tax insurance to streamline the deal negotiations by removing a potentially contentious beneficial ownership risk from their discussions.

Example 3: Debt financing

Real estate assets (or shares in real estate holding companies) are normally financed with a mixture of equity and debt. Besides providing leverage, debt financing enables investors to offset interest expenses against income derived from an asset, thereby reducing taxable profits.

Tax advisors across APAC are noticing an uptake in the number of challenges by tax authorities regarding the deduction of interest expenses, particularly when it involves related party debt. Oftentimes, tax authorities argue that the debt is not attracted for 'genuine commercial reasons' and recharacterize it, in full or in part, as equity contribution or make a downward adjustment to the interest rate. Such challenges could result in unforeseen tax bills affecting the return on investment. Chang mentions:

"Documentary evidence is critical to support the business needs for debt to be issued by related parties. Without detailed information to substantiate the need for financing from related parties, investors may be exposed to unintended additional tax liability. Since any challenge by the tax authorities will be levied post-transaction, buyers should carefully consider financing options and the potential tax risks prior to debt financing."

Teo adds:

"In Singapore, it is common for properties to be acquired via a share deal. However, interest expenses incurred on loans obtained post-acquisition are often not, in full or in part, deductible if the proceeds are being used to extend as interest-free loan or dividend payment to the new shareholder. Where there are genuine commercial considerations, the subject property may be transferred to a new entity in order to achieve a full deduction on the bank loan interest expense, greatly enhancing the after-tax return to investors. Such strategies are most relevant to core investments which are expected to be held for a substantial period of time. These strategies need to be carefully structured, with the commercial rationale properly documented in a contemporaneous manner. However, the longer holding period as compared to opportunistic investment makes such strategies and structures more susceptible to challenges by the IRAS. To provide certainty to investors on the efficacy of these strategies, obtaining a tax policy is highly recommended."

Closing

In conclusion, tax insurance is a valuable tool when it comes to dealing with tax risks in real estate transactions. It mitigates tax risk in an efficient and cost-effective manner. For a confidential discussion, don't hesitate to get in touch with us:

Contacts

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