Light on the matter

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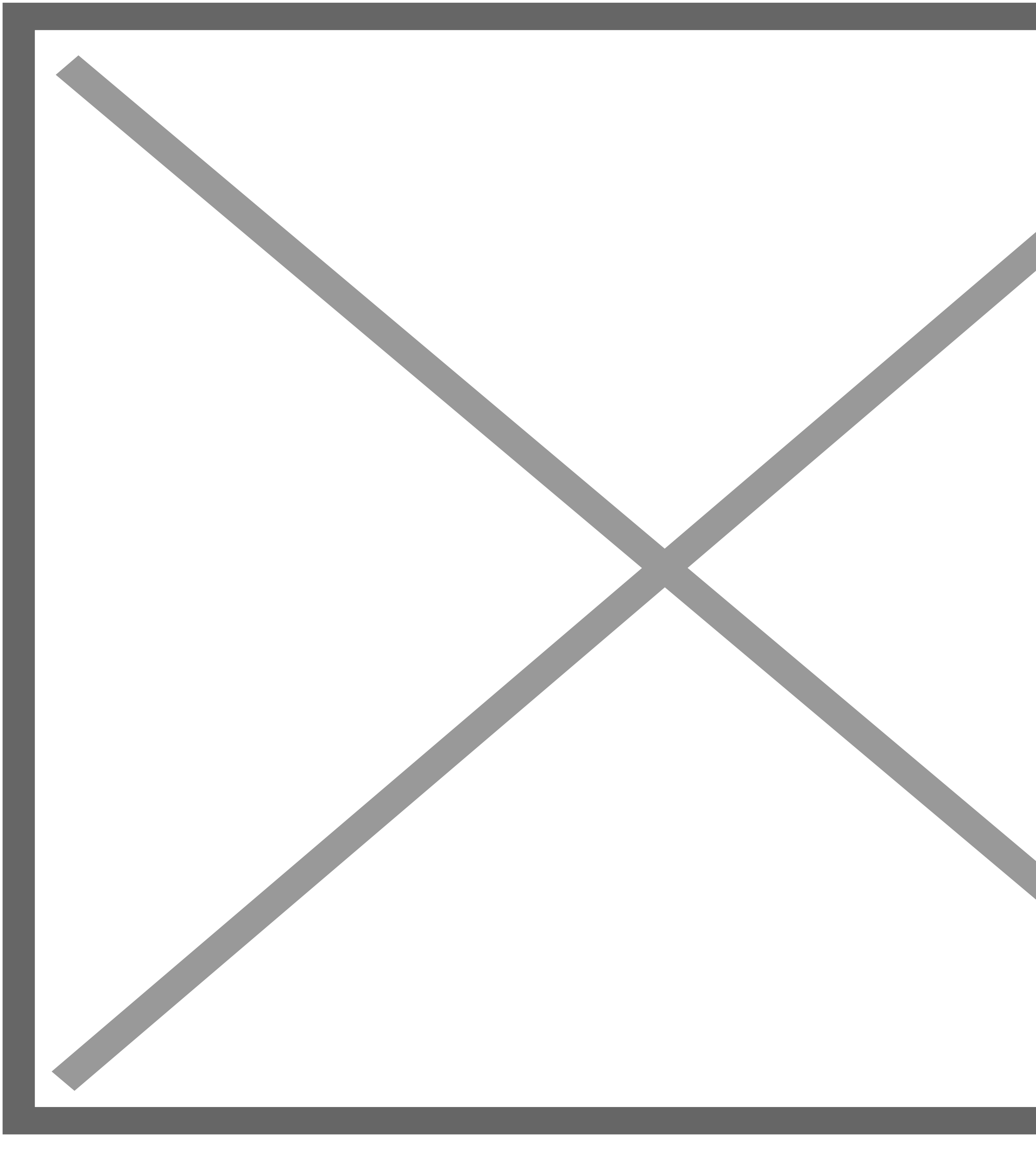

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Satvi Vepa provides a guide to the main tax provisions in share purchase agreements and tax deeds

Key Points

What is the issue?

The different routes to redress a buyer has under the tax deed and tax warranties demonstrates the different roles each of these play in a transaction and the importance to the buyer of having a tax deed in place.

What does it mean to me?

Anyone advising clients on the use of tax deeds or warranties should ensure that they are aware of the number of differences between the protections a buyer derives from a tax deed and from tax warranties. The tax deed and tax warranties should be carefully reviewed by a tax adviser.

What can I take away?

A greater understanding of the role of the tax deed and tax warranties and market standard tax indemnities and exclusions.

This two-part guide (the second part will appear in a future issue) goes through the role of, main provisions in and current trends relating to tax deeds and tax provisions in share purchase agreements (SPAs). This part will look at the role of the tax deed and tax warranties and market standard tax indemnities and exclusions.

Tax deeds vs tax warranties

'Tax deeds', 'tax indemnities' and 'tax covenants' (although there are technical differences between each of these terms) are all commonly used to describe the same thing – the document or provisions that are used to allocate tax risk on the sale and purchase of a company (the 'Company'). In this article we will refer to 'tax deeds' when describing the document used to set out the relevant provisions and to 'tax indemnities' when describing specific tax covenants to pay within the tax deed. Tax liabilities relating to periods prior to the sale of the Company ('Pre Completion Periods') stay with the Company after Completion. Therefore, to give a buyer comfort that the Company does not have large outstanding tax liabilities relating to Pre Completion Periods ('Pre Completion Tax Liabilities'), a seller usually provides a buyer a tax deed as a *covenant to pay* the buyer the amount of any Pre Completion Tax Liabilities on a £ for £ basis (albeit subject to certain limitations and exclusions).

Tax warranties are statements provided by a seller and typically found in the SPA. For example 'Each Group Company is, and [in the 3 years ending on Completion] always has been, resident only in the United Kingdom for Tax purposes.' The role of tax warranties together with the diligence process goes to the heart of the English legal principle *caveat emptor*, which puts the duty of inspection on a prospective buyer. The warranties are also another form of contractual protection given by a seller – to the extent disclosure is not made or is inaccurate, a buyer will have a claim for breach of contract against a seller.

There a number of differences between the protections a buyer derives from a tax deed and from tax warranties.

Some of the key differences are:

Disclosure: A seller may disclose against a tax warranty to the extent they are not true or accurate and remove themselves from being in breach of that tax warranty. However, any disclosure a seller makes in respect of a tax warranty will not remove the seller from liability under a tax deed. So when a tax deed is provided the tax warranties are seen primarily as a mechanism for eliciting information from a seller.

Breach of contract vs debt claim: Where there is a breach of a tax warranty, damages are awarded to the buyer based on the proven loss suffered by the buyer and there is a duty on the buyer to mitigate loss. The buyer is put back into the position he would have been in had there been no breach of warranty. However, a claim brought under the tax deed results in a £ for £ debt claim and there is no obligation on the buyer to prove loss or to mitigate. Therefore, a claim under the tax deed provides a clearer, quicker and more efficient way for a buyer to obtain redress.

Look back periods: Both diligence and tax warranties are usually limited to look back periods of between three to six years ending on the date of Completion. For example, in the warranty stated above, the look back period is three years. Note that this is not the same as the time limit for bringing claims (see below). Therefore diligence and tax warranties only provide the buyer with information relating to relevantly recent activities of the Company. However, the tax indemnities in the tax deed usually cover all Pre-Completion Periods. This is particularly relevant where there is a Pre Completion Tax Liability that has been caused by a careless or deliberate act.

The tax indemnities

Pre completion

Tax deeds contain a number of market standard tax indemnities. Most important is the general tax indemnity covering any ‘Liability for Tax of the Company arising in respect of, by reference to or in consequence of any income, profits or gains earned, accrued or received on or before Completion or any Event which occurred on or before Completion’. This indemnity is purposefully broad and unless specifically excluded, all Pre Completion Tax Liabilities should be caught by it. To ensure this is the case, defined terms (such as Liability for Tax, Event and Tax) should be checked carefully.

Post completion

There are also some key tax indemnities that should be included in the tax deed on behalf of a buyer as they relate to liabilities arising post Completion and therefore would not be covered by the general indemnity discussed above. This includes tax indemnities relating to secondary liabilities – where the tax liability is the primarily liability of another person but under secondary liability legislation, can fall on the Company after completion, when PAYE and NICs on options granted prior to Completion are exercised, released, disposed or varied after Completion or where under Part 7A ITEPA 2003 a ‘relevant step’ is taken after Completion as part of a ‘relevant arrangement’ which was put in place before Completion.

A buyer may also try and extend the definition of ‘event’ which is used in the general tax indemnity to include a series or combination of events only the first or some of which occurred on or before Completion. This broadens the general tax indemnity to cover the post Completion liabilities mentioned above. However, sellers would likely reject this as it is too broad (note there are compromise positions that may be accepted).

Limitations

Tax indemnities are generally limited by specific exclusions, financial limits and time limits.

Specific exclusions

It is common for the seller to include a number of exclusions to liability. Three key exclusions are summarised below.

An important exclusion is that the seller will not be liable to the extent that the liability (usually excluding a liability for deferred tax) is provided for in the Accounts of the Company. The rationale behind this exclusion is that the seller should not be liable to the extent the tax liability has been priced into the transaction. Therefore it is important that the buyer checks how the transaction has been priced. If the deal as been priced, for example on a multiple of EBITDA, then arguably the seller should not benefit from this exclusion.

Another important exclusion is that the seller will not be liable to the extent that the liability arises as a result of a voluntary act of the Company of the buyer after Completion outside the ordinary course of business of the Company. The buyer may limit this exclusion in a number of ways for example by stating that it only applies to acts which the buyer knew (or ought reasonably to have known) would give rise to the liability in question or by carving out acts required by law. Buyers may also try to carve out the act of disclosure to a tax authority. This is usually strongly contested by sellers even though technically it is not the act of disclosure which gives rise to the liability. Qualifying the act of disclosure as being *necessary* or (to track the terminology of Schedule 24 of FA 2007) *prompted* may be compromise positions.

Where the transaction is a ‘locked box deal’, it is also market standard to include an exclusion for any liability arising in the ordinary course of business during the leakage period. The reason for this is that economic ownership has essentially changed hands at a specific date prior to Completion and therefore any liabilities arising between that date and Completion should not be covered by the seller unless they are outside the ordinary course of business.

Financial limitations

A seller’s liability under the tax deed is usually limited to the amount of consideration. However, it is not market for the seller to have the benefit of minimum financial thresholds that need to be exceeded before a claim under a tax deed can be brought. The financial limitations are commercial points to be negotiated between the parties.

Time limits

The tax deed is usually subject to a time limit for bringing claims. The length of the time limit can be negotiated but it is usually between three and seven years to track the time limits that HMRC have to raise an enquiry. Most SPAs and tax deeds will specifically state that no limitations will apply in the case of fraud or deliberate default by the seller.

Takeaways

The different routes to redress a buyer has under the tax deed and tax warranties demonstrates the different roles each of these play in a transaction and the importance to the buyer of having a tax deed in place. The general tax indemnity should cover all Pre Completion Tax Liabilities but the buyer should be mindful of certain liabilities which may arise post completion and which they would want protection for. The tax indemnities are always subject to the limitations and exclusions and therefore these should always be checked carefully.