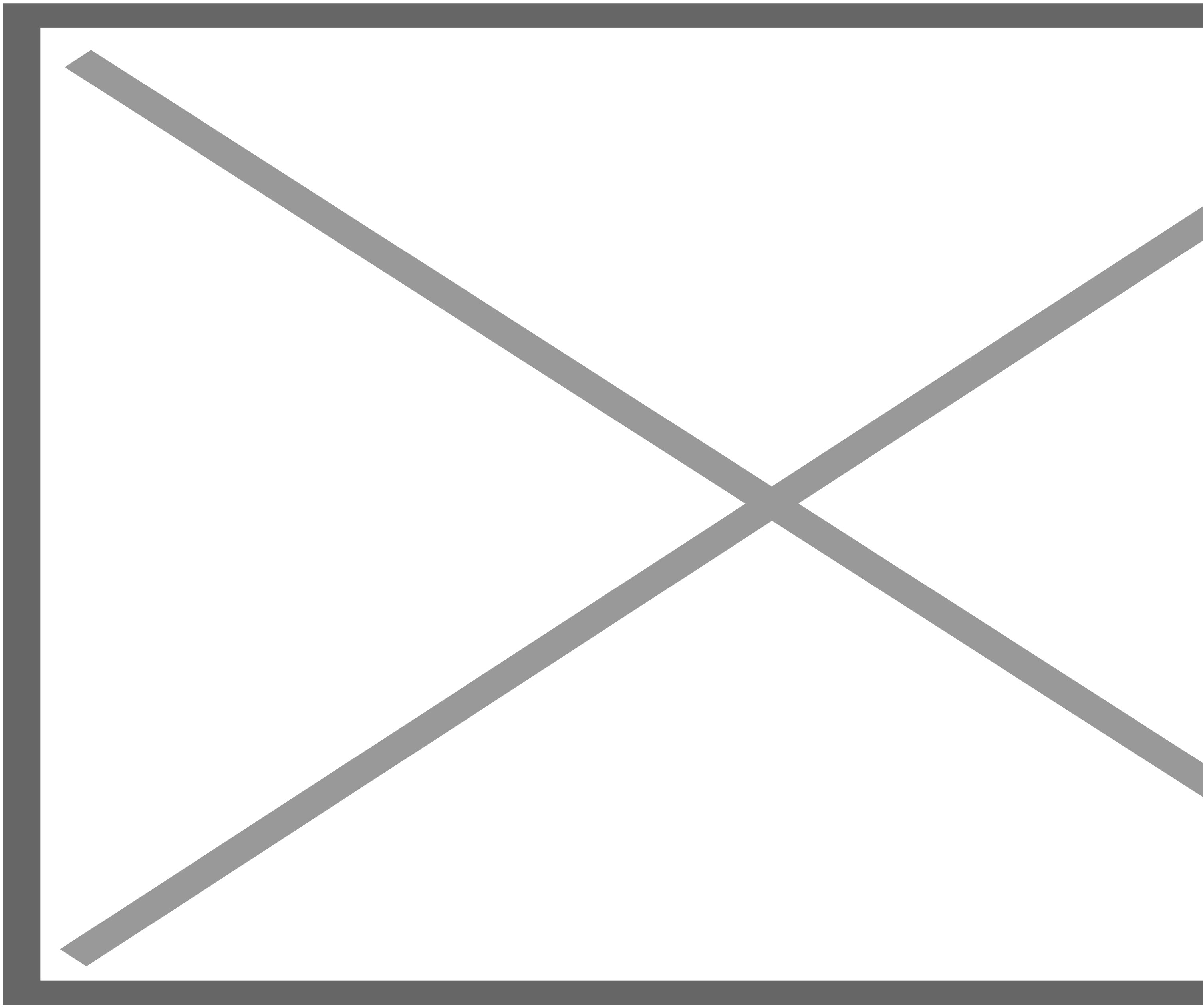
Better protection

Large Corporate OMB



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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?

Although the tax deed is provided for the benefit of the buyer, there are a number of seller-friendly clauses that may be inserted to create a more balanced document.

What does it mean to me?

Anyone advising sellers on the use of tax deeds or warranties should ensure adequate seller protection are included and should understand the impact of W&I insurance on the transaction documents.

What can I take away?

A greater understanding of some common issues on SPAs and tax deeds that arise for a seller.

This two-part guide (part one, 'Light on the matter' was in the September 2018 issue of *Tax Adviser*) goes through the role of, main provisions in and current trends relating to tax deeds and tax provisions in SPAs. This part looks at specific seller protection clauses, the role of the gross up clause and trends surrounding warranty and indemnity ('W&I') insurance.

Seller protections

Although the tax deed is provided for the benefit of the buyer, aside from the standard limitations and exclusions, there are a number of seller friendly clauses that are typically inserted in a tax deed. The main clauses to look out for are:

Conduct of tax claims and compliance

Where it becomes apparent that there is or may be a claim under the tax deed (a 'Tax Claim'), it is usual for the seller to have certain rights over how that claim is dealt with. A buyer would be reluctant to allow a seller too many rights such as allowing the seller to conduct negotiations directly with a tax authority in the name of the Company. It is also standard for the buyer to insist on an indemnity (or where more protection is required, security) for any costs incurred by the buyer or the Company in complying with the sellers instructions.

Similarly, the seller would want to have input into the tax returns and associated documents submitted to a tax authority in respect of Pre-Completion Periods. In most cases, these will not be finalised prior to Completion. From the buyer's perspective, the buyer should not be compelled to include the seller's comments if they do not think they are reasonable. Typically, the seller's rights under the Conduct clause takes precedence over their rights under the compliance clause.

These clauses are usually important to the buyer and seller and should achieve the correct balance of rights and obligations between the parties.

Savings, overprovisions and recovery from third parties

There are a number of cases where the Company may benefit from a payment or relief after Completion which relates to a Pre-Completion Period. A seller would argue that such amounts should be for their benefit. The usual scenarios are:

- A saving: where the seller has paid an amount in respect of a Tax Claim and a relief arises in respect of such payment. For example, if the liability was in respect of PAYE and NICs, there should be a corresponding corporation tax deduction.
- An overprovision: where a provision for tax in the Accounts has been overstated or a relief in the Accounts has been understated. Arguably this should only be relevant where the transaction has been priced on the Accounts.
- Recovery from Third Parties: where the seller has paid an amount in respect of a Tax Claim and the buyer recovers amounts in respect of the same liability from a third party (often excluding current and future employees or directors of the Company).

From the buyer's perspective all of these clauses should be subject to time limits so that the buyer is not bound by an ongoing obligation. The author would expect the time limit to match the time limit on claims made by the buyer under the tax deed. However there is an argument that the time limit under the savings, overprovisions and recovery clauses should be slightly longer as Tax Claims may be made on the last day of the Tax Claim time limit and so the corresponding saving or recovery may only arise after the Tax Claim time limit has expired.

In addition, where the seller benefits from a low financial limits on claims, it seems reasonable that the savings, overprovisions and recovery from third parties clauses are similarly limited. One way of achieving this would be to require the Company to first use the saving, overprovision and recovery against any liability it has suffered but which the seller is not liable for under the tax deed as a result of the low financial limit, and only give the seller the benefit of any excess saving, overprovision or recovery.

The clauses need to be carefully considered in the context of the deal.

Other common clauses seen in the tax deed which a seller may be keen on including are 1) the Buyer's Covenant relating to secondary liabilities falling on the seller as a result of the buyer or the Company failing to discharge their tax liabilities post Completion, 2) de-grouping clauses, 3) transfer pricing clauses and 4) group relief clauses. Including all of the seller friendly clauses creates quite a lengthy document so contrary to expectation, a short form tax deed is typically not a simplified tax deed but the sign of an aggressive buyer!

Gross up

Following the case of *Zim Properties v Procter* [1985], it is accepted law that a payment made under an indemnity constitutes a disposal of a chose in action which is a capital asset. Therefore a capital gain arises on the disposal which is usually equal to the whole amount of the indemnity payment (there generally being no base cost). ESC D33 allows indemnity payments made between a seller and a buyer to be treated as an adjustment of consideration thereby preventing a gain arising on the disposal.

To fall within ESC D33 it is important 1) for the indemnity to be between the seller and the buyer (and not the Company), and 2) to note that you cannot reduce consideration below £0 and so where any indemnity payments are in excess of the consideration, there will be a capital gain.

For domestic transactions it is standard for the seller to 'gross up' indemnity payments for withholding tax or tax in the hands of the buyer – the seller will pay additional amounts to the buyer to ensure that it is not left out of pocket. The seller usually accepts this clause on the basis that the risk of having to gross up is low; limited to situations where it is not possible to adjust the consideration or where there is a change in law.

On cross border transactions, the author's view is that gross up by a seller is more contentious and negotiable. Ultimately, negotiations come down to which party is prepared to take the risk.

It is worth noting that a gross up clause may be included in the tax deed as well as in the SPA and that gross up clauses can also be given by the buyer if the buyer is providing indemnities to the seller (such as the Buyer's Covenant). As such, a gross up clause should be carefully worded to ensure that it does not apply to the consideration.

Warranty & indemnity insurance

It is becoming increasingly common for parties to take out W&I insurance on transactions. Usually, where a buyer takes out W&I insurance this means that the seller's liability will be limited (this could be to £1 although the sellers may agree to a higher limit for specific liabilities) and the tax deed acts purely as a a supplementary document containing negotiated exclusions and limits.

Insurers still expect the tax deed to be negotiated to a reasonable position. However, a number of clauses may become less important or even irrelevant (such as, in the case of a buyer side W&I policy, the conduct of claims and the gross up clause – as the seller's liability is capped).

Buyers should be made aware that there are a number of differences between the protection obtained and obligations they are under where W&I insurance is involved in comparison to a standard Tax Claim. For example:

- **Exclusions**: Insurance policies typically exclude liabilities arising from transfer pricing, the non-availability of any losses or tax reliefs, secondary liabilities or where the insured had knowledge of the liabilities prior to Completion. These exclusions are quite wide ranging, especially if a detailed diligence process has been undertaken and detailed disclosures have been made against warranties.
- **Mitigation**: There is usually a duty on the insured to mitigate any loss or potential loss that is being claimed under the W&I policy. This is not the case where a claim is made against a seller under the tax deed.
- **Subrogation**: In a tax deed, the buyer may agree to a recovery from third parties clause. However, insurers usually insist on stronger rights of subrogation which is the right of an insurer, to ‘step into the shoes’ of the insured and to exercise any rights which the insured has against a third party. Unlike the recovery from third party clause, subrogation clauses do not typically exclude recovery against employees or directors of the Company and are not subject to a time limit.

Takeaways

Although the tax deed is provided for the benefit of a buyer, there are a number of seller friendly clauses that may be inserted to create a more balanced document. W&I insurance, specifically buyer side policies, means that the seller has very little 'skin in the game'. However, a buyer should be aware that there are a number of differences between the protection a buyer obtains and the obligations a buyer is under where buyer side W&I insurance is involved in comparison to a tax claim.