

Tax Covenant: **What you really need to know**

The Tax Covenant is the main protection a buyer has against potential unexpected tax liabilities in the target company. The covenant is sometime a standalone deed, a separate schedule to the sale purchase agreement or in a tax schedule that also includes the Tax Warranties. It matters little which form is taken, apart possibly from the execution formalities.

The Tax Covenant is, in essence, a promise by the Seller to pay to the Buyer an amount equal to a tax liability that has arisen in the target company, with its function being to adjust the price where the target company is worth less than the Buyer thought. If such a liability had been known before completion, the parties could have adjusted the price in advance. The Tax Covenant can therefore be summarised as a post completion price adjustment mechanism and it operates by reference to the deal accounts, whether they are the last accounts, completion accounts or locked box accounts. The type of accounts used as the reference accounts will affect how the Tax Covenant is drafted.

The most straight forward liability the Tax Covenant covers is an actual liability to tax suffered by the target in relation to pre-completion events that have not been provided for in the reference accounts. However, the Tax Covenant goes further than this, as it covers protection for:

1. reliefs from tax (often referred to as tax assets), which are used to extinguish a pre-completion tax liability; and
2. the loss or non-availability of a relief from tax where the buyer has either, specifically paid for those reliefs or where the availability of pre-completion reliefs was a factor in arriving at the purchase price, which is generally where such reliefs are shown as an asset in the accounts.

The Tax Covenant typically covers other more specified tax liabilities including secondary liabilities and identified liabilities/risks.

The covenants given by the seller are usually wide ranging and so the Tax Covenant is structured so that there are a number of limitations to ensure that a buyer cannot bring a claim where it would be unreasonable to do so. The most important of these limitations is where a tax liability is provided for in the reference accounts and (except where completion accounts are being used as the reference accounts) any tax liability that arises in the ordinary course of business activities in the period between the accounts date and completion.

In addition to the Tax Covenant, the tax schedule (or separate deed) will contain important provisions as to how tax returns for accounting periods that straddle the completion date will be dealt with post-completion, as well as how tax disputes that relate to pre-completion tax liabilities will be handled.

This article touches upon the main points of the Tax Covenant, which is a complex and technical document that can have significant costs to a seller and benefits to a buyer and specialist advice should always be taken when drafting and negotiating it.