

Share Sales: **The Apportionment of Tax Risk**

Acting for the Buyer

When a Buyer acquires shares in a target company, they are acquiring the shares in a taxable entity that has tax liabilities and obligations that precede the period prior to completion (commonly referred to by the tax bods as a “Pre-Completion Tax Liability”). This carries an inherent risk for the Buyer, as they are in effect buying the company with Pre-Completion Tax Liabilities which may only surface post-completion. This risk must be managed and there are various ways in which to do this, including taking appropriate tax advice at the heads of terms stage of the transaction, ensuring suitable tax due diligence is carried out on the target company and having a set of tax warranties and a tax covenant in the sale and purchase documentation.

Without the protections contained in the sale documentation, the Buyer would be exposed to the risk of pre-completion tax liabilities of the target company that may not have been revealed in the tax due diligence and which are not recognised in the accounts. For these purposes the tax warranties and the tax covenant come into play. However, these two concepts work a bit differently than perhaps other elements of a SPA.

In particular, tax warranties are very seldom ever used by a Buyer to sue for damages. Why? Well, like all warranty claims, we need to establish loss, a breach and a causal link between the two. No need to bother when you have a tax covenant; this allows for a straight forward pound for pound recovery where a claim falls within the scope of the covenant, subject to the negotiated Seller limitations.

So why even bother with warranties?

Well, when these targeted warranties flush out pertinent information in the disclosure exercise, a now well informed Buyer and corporate advisor will have some decisions to make. Depending upon the risk and the degree of certainty/uncertainty of it crystallising, various courses of action may be considered. For example:

- Specific indemnities – sitting outside normal limitation schedules in a SPA.
- Escrows / retention of funds.
- Price chips.
- Deal abortion.

Acting for the Seller

The tax covenant however also contains Seller protections to balance out these risks, for example if tax is provided for in the last accounts, completion accounts or locked box accounts (as appropriate) then no claim can be made. This has the effect of apportioning the risk.



As the tax covenant and the tax warranties are an important and integral part of the sale and purchase documentation to almost all share transactions, we will examine them in greater depth in the next few bulletins. It should however be noted that appropriate advice should be obtained in respect of these as they must reflect the deal (including the pricing mechanisms) and not conflict with the rest of the sale and purchase documentation. To do this is it often necessary to liaise with accountants, external tax advisers and of course the corporate lawyers.