

Heads of Terms: **Beware Tax Traps!**

The heads of terms (which are also known as letters of intent, heads of agreement or memoranda of understanding) (“HOT’s”) set out the terms as agreed between the parties of a sale and purchase. They are often a comparatively short document and evidence serious intent, but are not automatically legally binding. In fact, depending on how they are drafted they can either be fully binding, partially binding or not binding at all.

Their purpose is generally to help to avoid later misunderstandings and confusion. However, the HOT’s themselves can have significant tax consequences and the parties should be taking tax advice. One classic example of how the parties can trigger a Tax Trap is that signing the HOT’s may be regarded as amounting to an “arrangement” for the disposal of the target company, which can have the unexpected consequence of affecting the Seller’s ability to claim tax losses or affect the availability of the target company to surrender its losses to other group members. Both of which could see a massive amount of real value lost and potentially undermine the deal itself.

At other times a transaction may be primarily driven by tax considerations and documents may be tax sensitive. The HOT’s may be a good place to set out the commercial rationale for a transaction, thereby potentially avoiding the argument with HM Revenue & Customs that the transaction has been undertaken for tax avoidance purposes. Conversely, the failure to include the commercial rationale for a transaction may assist HM Revenue & Customs in challenging a transaction on the grounds of tax avoidance. Either way, careful thought is needed.

Finally, even if the HOT’s are not legally binding for a particular transaction, given that the parties are agreed to the principle that they lay out, if a tax issue arose for one of the parties as the matter progressed and they wanted to change the terms of the transaction in some way, the other side is less likely to be accommodating if the principles as set out in the HOT’s are varied and the onus is likely to be on the party requiring variation to bear any costs. Therefore, each side needs to ensure that the HOTs properly reflect the agreed allocation of tax risk between the parties, as well as properly reflecting the value of any tax benefits (for example, any tax deduction that arises on the exercise of options in the target as part of the deal).

HOT’s can have real and significant tax consequences and so must be source checked before agreed.