FOCUS

A NEW CREED FOR THE TAX DEED

The impact of market trends

Most advisers will agree that the primary purpose of the tax deed is to allocate risk of unexpected tax exposure between the buyer(s) on the one hand, and the seller(s) on the other. This tends to mean that the seller will usually assume tax risk up to a certain date, such as the date on which the transaction closes, unless there are specific concerns that merit a more bespoke allocation. However, while this premise is simple enough, tax deed negotiations are often anything but.

At one time, the negotiation of the tax deed was a relatively formal process, with each party relying heavily on its own precedent. However, the comfort afforded to advisers by the use of their own standard form has become increasingly outweighed by the need for the tax protections to be commercially relevant to the deal, particularly in sector-specific or multi-jurisdictional cross-border transactions (*see feature article "M&A tax protections: UK and US market practice", www.practicallaw.com/2-578-3646*).

Equally, the economic downturn that ensued after the 2008 financial crash led to parties placing greater emphasis on the availability of tax assets, and the ability of the seller (as opposed to the buyer) to derive value under the tax deed for unexpected tax refunds or other tax-related benefits; concepts that are not always sufficiently catered for in standard form documents. If the more pessimistic reactions to the Brexit vote prove to be accurate, and the UK slides into another recession, there may be a renewed interest from buyers in safeguarding any tax assets, such as trading losses, that arise.

Procedure

Although the allocation of risk is principally dealt with in the covenants and exclusions that usually appear at the front of the tax deed, advisers will overlook the more prosaic procedural provisions at their peril (*see Briefing "The changing face of tax deeds: are you aware?", www.practicallaw.com/7-539-3466*). As demonstrated in *Teoco UK Ltd v Aircom Jersey 4 Ltd*, a failure to comply with procedural requirements may completely undermine the value of the covenants (*[2015] EWHC (Ch); www.practicallaw.com/3-630-2207*).

In *Teoco*, Teoco's claims in respect of certain tax liabilities were barred because it failed to comply with the precise requirements under the contractual notice provisions, which specified that the buyer must give notice to the seller as soon as reasonably practicable after becoming aware that it had a claim, and that the notice must include reasonable details of the claim, including the grounds on which it was based and a good faith estimate of the quantum.

The High Court found that, although Teoco had given notice to Aircom Jersey in the form of two letters, that notice was not valid because:

- It would not have been clear to a reasonable recipient that the letters constituted notice of the making of a claim.
- The letters did not specify the particular warranties that were alleged to have been breached; a generic reference to warranty claims or tax claims did not suffice.

Further, with respect to one of the claims, the court found that Teoco did not notify Aircom Jersey as soon as reasonably practicable. As a result, Teoco's claims were dismissed.

Teoco demonstrates the difficulties that may arise when interpreting procedural provisions and the practical significance of non-compliance. Helpfully, *Teoco* provides some insight into how courts may construe the following terminology, which is typically used in these provisions:

- Reasonable details: this will not, generally, mean that the details need to match the level of detail required in court pleadings, but there must at least be a clear identification of the claim.
- The grounds on which the claim is based: these details must include identification of the specific warranties breached or the basis for the tax indemnity claim.
- Good faith estimate: good faith means honest, but does not import any greater obligation such as objective reasonableness.

Change of law exclusion

Typically, tax deeds will include various exclusions from the seller's obligations under the covenant. One typical exclusion covers tax liabilities that arise from, or are increased by, changes in law, and it is often the case that the buyer will assume the risk of tax liabilities arising due to a change of law that takes place after the date the transaction closes.

Court decisions. Although this might at first sight seem a straightforward exclusion, difficulties often arise, particularly in relation to judicial decisions. Litigation with HM Revenue & Customs (HMRC) generally turns on legislative interpretation, and it may not always be clear to what extent a decision on a particular point actually represents a change in law. Often the decision is extremely fact-specific, with questionable application to other taxpayers. Even where the decision is clearly of universal application, it may not be considered appropriate to treat it as a change of law if, like many tax decisions, it is the subject of an appeal.

Courts may also decide a tax case in a way that departs significantly from long-standing HMRC practice: should that represent a change in law and does the answer depend on whether the decision leads to HMRC

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amending its published view? Examples of these decisions include *HMRC v Anson* and *McQuillan v HMRC* (*[2015] UKSC 44, www.practicallaw.com/1-618-3093; [2016] UKFTT 305 (TC), see Focus "Ordinary share capital: can a negative prove a positive?", www.practicallaw.com/2-631-2725*).

Key questions worth considering in this context include:

- Whether a single first instance decision, which does not bind other courts, constitutes a change in law.
- What would happen if there are two conflicting first instance decisions, such as the First-tier Tribunal's interpretations of ordinary share capital in *McQuillan* and *Castledine v HMRC* (*[2016] UKFTT 145 (TC), www.practicallaw.com/3-627-1036*).
- Whether the drafting should specify that a change of law only occurs once there is a final decision; for example, once all appeals have been exhausted or leave to appeal has been refused.
- What should happen in a scenario like *Anson* where the court decides one way, but HMRC announces that its practice will continue in the other way.

Brexit. Business and advisers have been assessing the impact that Brexit may have on business structures and operations. Although, from a tax perspective, there may be no immediate impact, the medium to long-term implications of Brexit on UK tax law remain uncertain, and this uncertainty may have an impact on tax deed drafting.

It is worth considering whether any Brexit-related tax liabilities arising post-completion should be treated in the same way as other post-completion exposures. Buyers may now consider asking for protection with respect to post-completion tax liabilities that arise as a result of pre-completion arrangements no longer falling within the scope of EU regimes following Brexit; for example, intra-group arrangements no longer falling within the scope of the Parent-Subsidiary Directive (*2011/96/EU*). Conversely, sellers may argue that this type of request would cut across the traditional risk allocation under a tax deed. Ultimately, which party ends up bearing this risk is a commercial question to be answered by the parties, depending on, among other things, their respective bargaining positions and any particular sensitivities.

Buyer's covenant

Sellers often include a buyer's covenant in the tax deed. These provisions frequently include protection for the seller in respect of any tax for which it may become secondarily liable were the target not to settle its post-completion tax liabilities. Conceptually, this effectively mirrors the obligations of the seller that are typically included in the covenant. However, buyers are increasingly requesting that their covenant is subject to at least the same degree of limitations as the seller's equivalent covenant.

Insurance

In recent years there has been a noticeable increase in warranty and indemnity insurance being taken out in respect of corporate transactions. This insurance often provides protection for losses that arise as a result of a breach of a warranty or claim under an indemnity, including those relating to tax under the sale and purchase agreement or the tax deed. This trend has a direct impact on the negotiation of the documents.

Where the buyer has full recourse under the insurance for items that are covered by the tax deed, the seller will likely want its liability capped at a de minimis amount. However, insurance policies typically contain exclusions that limit buyer protection, which may not always match those contained in a tax deed. For example, a tax deed might cover specific liabilities identified as risks during the due diligence process, whereas many insurers will not underwrite (as part of a general warranty and indemnity policy) risks that are known to the insured.

Similarly, secondary liabilities and the non-availability of tax assets which have been paid for by the buyer are often included in tax deeds, whereas that is not necessarily true of insurance policies. Buyers may therefore consider asking the seller to stand behind those exposures that are not covered by the insurance policy. If that approach is deemed appropriate, the cap could be lifted for those exposures that the seller is prepared to cover.

It is also important to consider whether it is appropriate to include provisions in the tax deed stipulating how tax assessments are to be conducted. In the absence of an insurance policy, sellers may wish to have conduct of, or significant input into, any discussions with the tax authorities that may lead to a claim under the tax deed. This may not be appropriate in cases where the seller is not potentially responsible for any amounts that become payable under the tax deed following those discussions. It is likely that the insurer may have a greater interest in the outcome of those discussions, and therefore a stronger claim to being involved.

In addition to the above, the following points should be borne in mind:

- Unlike tax warranty claims, tax covenant claims are not generally subject to the duty to mitigate. However, insurers may subject the insured to a duty to mitigate in respect of all claims under the policy which may result in the premature settlement of disputes.
- Tax deeds contain provisions setting out the payment date in respect of amounts falling due under the tax deed. The payment provisions in an insurance policy may not operate in the same way.
- The tax treatment of insurance proceeds is complicated. It should not simply be assumed that the receipt of insurance proceeds will be tax-free.

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