M&A TAX PROTECTIONS
UK AND US MARKET PRACTICE

Oliver Walker, Mark Schwed, Erica Rees and William Dong of Weil, Gotshal & Manges compare UK and US market practice on how to protect companies from tax exposures in M&A transactions.

On large cross-border acquisitions of private companies, tax advisers often need to understand the prevailing market practice in multiple jurisdictions. While knowledge of the tax issues and how they are covered in the legal documents is key, it is also crucial to ensure that contractual provisions are not out of step with any accepted market norms.

This is especially true of auction processes, where unwitting tax advisers may prejudice a bid by, for example, demanding protections that are unacceptable in the relevant local jurisdiction, despite being routinely seen in mergers and acquisitions (M&A) in the tax adviser's own jurisdiction.

The corporate M&A markets in the UK and the US share many similarities from a legal and documentary perspective, but there are key differences in how to protect against tax exposures. Although the basic principles are the same; for example, protection for pre-completion tax liabilities is ordinarily provided to buyers through representations or warranties and indemnities, there are a number of significant differences in practice. This article summarises the market practice in the UK and the US, and highlights some important distinctions.

UK TAX WARRANTIES

Tax warranties are statements of fact regarding the target's (or target group's) tax affairs. They are given as at the time of signing and, depending on the specifics of the deal, are not usually repeated at completion (if that occurs on a later date), with the possible exception of certain fundamental warranties, and those warranties that cover matters in the seller's control. The buyer will rely on these statements when entering into the sale and purchase agreement (SPA), and can sue the seller for breach of contract in respect of any resulting loss should the statements later prove to be untrue.

If there is a breach of a warranty, the buyer can usually sue for damages (under an English law-governed contract, this will be subject to the normal rules for proving and mitigating loss for contractual damages claims) but cannot treat the contract as repudiated, so the buyer will still be bound by the SPA. Warranties are rarely given on an indemnity basis.

Although a tax covenant generally provides a more effective and efficient form of redress, tax warranties remain crucial in terms of flushing out potential tax-related issues through the disclosure process (*see "UK tax covenant" below*). Also, tax warranties will sometimes be forward-looking; for example, a warranty that the future disposal of an asset will not trigger an inherent deferred gain. In this case, the seller could find itself in breach due to a post-completion liability. It is therefore possible that the tax warranties may provide redress in cases

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Scope of UK tax warranties

Regardless of the seller's (or target's) position and any deal-specific features, tax warranties will typically cover some or all of the following:

- Filing obligations; that all accounts, computations and returns have been properly and timely filed, and are accurate and complete.
- Payment of taxes; that all taxes have been duly and punctually paid or deducted.
- Record-keeping; that the target has maintained accurate and complete tax records.
- Residence; that the target is not, and has not been, resident for tax purposes outside its jurisdiction of incorporation.
- Stamp duty; that any document necessary or desirable in proving the target's title to any asset has been duly stamped for stamp duty purposes.
- Disputes and investigations; that the target is not party to any disputes with, or subject to any investigations by, a tax authority.
- Anti-avoidance; that the target has not been party to any transactions in order to avoid tax.
- VAT; that the target is (or is not) registered for the purposes of VAT and is (or is not) a member of a group of companies for VAT purposes.

Other warranties may be necessary depending on, among other things, the target's ownership and group structure, the nature of the target's business, the types of assets held by the target and any other matters arising from due diligence.

Tax warranties may be more limited in scope where a tax covenant is being provided, although the two types of protection work differently and provide different forms of comfort. There is also a tendency to expect more extensive warranties when dealing with a trade seller (as opposed to, for example, a private equity house), which will generally have owned the target for a longer period and will therefore have a greater, more intimate knowledge of the business.

where no liability arises under the tax covenant, which will generally only cover pre-completion liabilities (*see box "Scope of UK tax warranties"*).

Limitations and exclusions

Tax warranties are generally subject to a longer limitation period than other warranties. Sellers are often expected to remain liable for breach of any warranty for the duration of the statutory limitation period in relation to corporation tax (the HM Revenue & Customs (HMRC) assessment period) in respect of carelessness, which is currently six years from the end of the accounting period to which the assessment relates. Therefore, a limitation period of six or seven years from completion is relatively common. Shorter periods are, however, often negotiated and often seen in a private equity context, depending on the specifics of the deal.

In addition to a time limit, tax warranties are often subject to the same limitations and exclusions that are in the tax covenant, including, for example, where provision has been made for the relevant liability in the company's accounts. In line with most warranties, but in contrast to the protections set out in a tax covenant, tax warranties are limited by disclosure and, often, qualified by the seller's awareness. In this case, the buyer would be precluded from bringing a claim under the tax warranties in respect of any matter disclosed by the seller, or about which the seller was unaware, but would still have a remedy in respect of that matter if it was covered by a tax covenant.

Any claim brought under the tax warranties contained in an English law-governed SPA would also be subject to common law rules of contract, including the buyer's duty to mitigate its loss and to prove breach, damage and quantum of loss.

UK TAX COVENANT

The tax covenant can either be incorporated into the SPA or drafted as a standalone document. It is sometimes referred to as a tax indemnity, although it is not, strictly speaking, an indemnity as it:

- Is generally given in favour of the buyer, rather than the target.
- Offers protection against the target's liabilities rather than the buyer's actual losses, which may not always be the same.

The purpose of the tax covenant is, in most cases, to provide the buyer with protection for unforeseen and unaccounted for historic tax liabilities of the target (or the target's group) (*see box "Scope of UK tax covenants"*). It generally operates to allocate risk between the seller and the buyer by drawing a line between two periods of time; that is, pre-completion and post-completion or, where a deal has been priced with respect to a specific set of accounts, pre-accounts date and post-accounts date.

It usually provides that tax liabilities arising from events occurring during the former period (the pre period) are to be borne by the seller, whereas tax liabilities arising from events occurring during the latter period (the post period) are to be borne by the buyer. However, protection against post-accounts date liabilities is usually limited to events occurring outside the ordinary course of business.

The provision of a tax covenant will depend on the particular circumstances of the deal but will often be informed by the parties' respective bargaining positions and the information (or lack of information) as to the target's affairs known to the buyer. That said, where the target is a public company, or private equity-backed, the transaction will often proceed without a tax covenant. Unlike a claim under the tax warranties, which is subject to common law rules of contract (*see "UK tax warranties" above*), a tax covenant claim provides the buyer

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Scope of UK tax covenants

A UK tax covenant will typically cover, among other things, tax liabilities of the target that:

- Result from any event occurring on or before completion.
- Would not have arisen but for the loss or reduction of an "accounts relief" (for example, a relief shown as an asset in the relevant set of accounts) or the non-existence or non-availability of this relief.
- Would have resulted from any event occurring on or before completion, but that are not payable due to the use of a "buyer's relief" (for example, a relief arising in respect of an event occurring after completion or an accounts relief).
- Fall on the target but which are primarily the liability of the seller.

Other indemnities may be necessary depending on, among other things, the target's ownership and group structure, the nature of the target's business, the types of assets held by the target and, most importantly, any other matters arising from due diligence or during the disclosure process.

with comparatively quick, pound-for-pound protection. The buyer makes a claim for a quantifiable sum (for example, £X of tax underpaid by the target during the pre-completion period, plus £Y of interest, plus £Z penalty) under the claims procedure set out in the tax covenant. If there is no dispute, the buyer will then recover the specified sum from the seller.

Parties to the tax covenant

Although it would seem logical for the tax covenant to be provided by the seller in favour of the target (as it is the target that technically bears any relevant liabilities), it is common practice in the UK, following *Zim Properties Ltd v Proctor (Inspector of Taxes)*, for the tax covenant to be provided by the seller in favour of the buyer with any resulting payments characterised as adjustments to the purchase price (*[1985] STC 90*) (*see box "Zim Properties"*).

Despite this standard approach, the target may still be a party to the tax covenant where it is subject to certain post-completion conduct rights or obligations set out in the covenant. There may also be instances where a guarantor is included as a party, depending on the buyer's view of the seller's creditworthiness.

Limitations and exclusions

It is typical for any liabilities under the tax covenant to be limited or excluded in certain circumstances, most commonly as follows:

- As with tax warranties, the seller's liability is often limited to six or seven years following the date of completion, in keeping with the six-year limitation period for HMRC assessments for carelessness. However, this time limit is often subject to negotiation and may be shorter depending on the specifics of the deal including, for example, where the party providing the tax covenant has had only a limited period of ownership or in a private equity context.
- The seller's liability may be subject to various financial limitations, despite the pound-for-pound concept underpinning the tax covenant. A de minimis threshold, where the seller is not liable unless the relevant claim meets or exceeds a certain amount will sometimes apply, although it is perhaps more common for the seller's liability to be capped (for example, by reference to the amount of consideration received by the seller) and/or (less commonly) subject to a basket, where the seller is not liable unless and until the aggregate liability under all claims exceeds a certain amount.

In addition, the seller's liability might typically be excluded in a number of additional circumstances, including where:

- Specific provision or reserve has been made for the liability in the relevant set of accounts (the rationale for this is that the buyer will have had the opportunity to factor it into the purchase price for the target).
- The liability has arisen as a result of a retrospective change in the law announced after the date of completion.
- The liability has arisen as a result of certain voluntary acts or omissions of the buyer (or the target) after the date of completion.
- The buyer has already been compensated for the liability in question.

Where the deal has been priced with reference to an accounts date preceding the date of completion, it is also typical to exclude the seller's liability where it arises from events occurring in the ordinary course of the target's business in the period between the accounts date and completion. The rationale for this is that, as the buyer has had the benefit of the target's ordinary course profits during this period, it is reasonable that the buyer should also bear the burden of the target's ordinary course tax liabilities during this period.

Conduct of tax affairs and tax claims

The tax covenant will also include provisions dealing with the conduct of the tax affairs of the target and claims brought by the tax authorities, although market practice is somewhat mixed on the allocation of responsibility.

In respect of tax affairs, it is important to specify how any tax returns, computations or other administrative matters relating to pre-completion periods (or any part of them) will be dealt with as between the buyer and the seller. In the UK, the sale of the target will not trigger the end of an accounting period, so it is important to address the conduct of tax affairs relating to straddle periods; that is, accounting periods starting before, but ending after, completion. This will be of particular importance to the seller, which, in the absence of any express provision to the contrary, will no longer have oversight of the target's tax affairs for pre-completion periods but will be accountable under the tax covenant for any liabilities relating to these periods (barring any applicable exclusion).

Therefore, where the buyer takes responsibility for pre-completion or straddle periods, sellers will generally want to be materially involved in the target's tax affairs. This may be through

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Zim Properties

Zim Properties Ltd v Proctor (Inspector of Taxes) established that a chose in action is a chargeable asset for capital gains tax purposes (*[1985] STC 90*). HM Revenue & Customs' (HMRC) Extra-Statutory Concession D33 (ESC D33) makes it clear that HMRC does not regard *Zim* as applicable to payments made by the seller to the buyer under a warranty or indemnity included in a sale and purchase agreement (SPA). These payments are instead treated as an adjustment to the purchase price for the underlying asset, and it is common for the tax covenant or SPA to state that payments should be treated as such. However, ESC D33 does not address payments made by the seller to the target company, which may be taxable.

preparing and submitting any relevant returns and computations for pre-completion periods (and managing any related communications with the tax authorities), or reviewing them and having reasonable comments taken into account.

To the extent that the seller takes responsibility for the management of tax affairs, the buyer may want the same rights as regards reviewing and commenting on documents and exchanges of information with the relevant tax authority, particularly as it would not want the seller's management of tax affairs to affect negatively its reputation. In either case, well-advised parties will include an express mechanism for how the procedure will work including, for example, deadlines for providing documents to the other party, and for responding with any comments.

There will usually be provisions for dealing with any tax authority assessments that may result in a claim. Again, the seller will usually want to be involved, with the aim of keeping its liability to a minimum, whereas the buyer will prefer a swift resolution with no damage to its, or the target's, reputation in the meantime and without increasing its post-completion tax liabilities. Typically, therefore, conduct of claims provisions will set out the respective rights and obligations of the parties, including:

- How and when any claim must be notified.
- Which party will have control of any dispute or negotiation with the relevant tax authority.
- To what extent the non-controlling party may comment on the manner in which it is handled, and to what extent those comments must be taken into account by the controlling party.
- The circumstances in which input from independent tax advisers (for example, accountants or counsel of a certain standing) may be sought as to the merits of any claim and the proposed manner for dealing with the claim.

Before allowing the seller to take conduct of any claim, the buyer will likely require indemnification (and sometimes some form of security) for the liability in question, including any costs and expenses that may be incurred in resisting that claim.

Seller-friendly provisions

Although the primary purpose of the tax covenant is to offer protection for the buyer, various seller-friendly provisions are now commonly included. These will often include credit for some or all of the following:

Tax overstated in the relevant set of accounts. Commonly known as an overprovisions clause, this ensures that the seller is credited for any tax liabilities that were overstated in the accounts or erroneously provided for, with the result that the purchase price was reduced.

Tax credits arising from a pre-completion event. In the same way that the tax covenant renders the seller liable for tax liabilities arising from pre-completion events, a common counter-argument is that the converse should apply to give the seller credit where the buyer (or target) benefits from a pre-completion event (for example, a refund of taxes incurred and paid before completion).

Tax credits arising from a tax indemnity claim. This is commonly known as a corresponding benefits clause, and would apply where the target receives a tax credit as a result of an item giving rise to a payment from the seller to the buyer. For example, if the target failed to operate PAYE properly in respect of pre-completion periods, the payment of any employer's National Insurance contributions that is covered by an indemnity claim could give rise to a tax credit for the target in the form of a corporation tax deduction.

Counter-indemnity. Often, the seller will expect credit where it becomes (secondarily) liable to tax as a result of an act or omission of the buyer or the target carried out after completion.

In any of the above scenarios, the seller will not necessarily receive payment. The buyer would usually prefer that the amount of any credit should be applied to, and set off against, any current or future liabilities of the seller under the tax covenant (or tax warranties, if so provided). Indeed, a cash payment may be problematic depending on any restrictions arising from the buyer's finance arrangements. Additionally, credit will not normally be given in respect of any item which has been included in the accounts and consequently operated to increase the purchase price.

Recovery from third parties. The tax covenant will also generally include a provision requiring the buyer to take any action that is reasonably requested by the seller to enforce recovery against a third party, where the buyer is entitled to do so, in respect of any liability covered by the tax covenant.

Withholding and grossing-up

Questions of withholding and gross-up obligations are bound to arise in any transaction with a cross-border element. No withholding tax should ordinarily arise on consideration paid out of the UK, and it would be unusual for the buyer to be asked to provide any specific gross-up in this respect. However, given the pound-for-pound protection afforded by the tax covenant, it is relatively standard for any payments made under it to be subject to a gross-up to ensure that the buyer is left with the amount that it would have received without any withholding requirement or any tax on receipt.

US TAX REPRESENTATIONS

As a general matter, tax representations (like other representations) serve three basic functions in a US SPA:

- In the same way as tax warranties in the UK, tax representations serve a

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due diligence function by facilitating the disclosure of potential liabilities, attributes and other issues associated with a target's tax profile.

- A breach of a tax representation may provide a basis for a claim for breach of contract or, in contrast to the standard UK position, an indemnification claim. Often, an SPA will specify that the sole recourse for recovery for breach of a representation is to proceed against the seller through an indemnification claim (*see "US indemnification provision" below*).

- Unlike in the UK, the tax representations theoretically can provide a basis for a buyer to refuse to close a transaction if the breach of a representation causes the failure of a completion condition that all representations are true except to the extent that failure to be true would not give rise to a material adverse effect. It should be noted, however, that it is reasonably unlikely that the breach of a tax representation would, in the normal course of events, give rise to a material adverse effect.

The tax representations generally focus on the target's (and its subsidiaries') tax liabilities, attributes and compliance, taking the form of statements of fact regarding the target's tax affairs (*see box "Scope of US tax representations"*). The seller will make most representations as at the date of signing and again as of the completion date. However, certain specified representations may be made as of a different date.

Limitations and exclusions

Like in the UK, tax representations in US deals are often subject to longer limitations periods than other representations and may survive for the full statute of limitations. However, in larger deals, public deals or those with a private equity seller, they often have limited or no survival at all following completion.

Often, tax representations are completely carved out of all of the limitations and exclusions that are applicable to claims for breaches of other representations; that is, they are often not subject to deductibles, baskets, mitigation or caps (other than, in certain circumstances, the purchase price). However, in more competitive processes, it is not uncommon for some limitations to apply.

Scope of US tax representations

In the typical transaction, irrespective of the nature of the target's tax position, the US tax representations will cover some or all of the following:

- Filing obligations; that all tax returns have been duly and timely filed, and are accurate and complete.

- Payment of taxes; that all taxes have been duly and punctually paid or deducted.

- Consolidated tax liabilities; that the target has not been a member of a consolidated group and is not liable for the taxes of another person, including under Treasury regulation section 1.1502-6, which makes all members of a consolidated tax group jointly and severally liable for the taxes of a consolidated group.

- Audits and investigations; that the target is not a party to any tax audits, actions, proceedings, and no such audits, actions or proceedings have been threatened.

- Tax liens; that the target's assets are not subject to any liens for taxes.

The scope of tax representations in an agreement and the extent of their coverage will depend on the nature of the target and the circumstances surrounding the transaction. For example, if the target is a public company, information about it will be publicly available in US Securities and Exchange Commission filings, so the buyer may conduct its own diligence.

In addition, the use of representation and warranty insurance, which is becoming more prevalent, especially in competitive processes, can affect the scope of tax representations as the buyer and seller are often aligned to shift risk to the insurance provider. With virtually no risk for any breach, the seller will naturally be less concerned about the representations included in the agreement. This trend is also now being seen in the UK market.

In addition, as with other representations and similar to UK deals, tax representations are qualified by disclosure, so a buyer cannot bring a claim if it arises as a result of an item that is disclosed against a representation. In US deals, however, anti-sandbagging provisions, which prevent a buyer from seeking a remedy for a breach of a representation that the buyer was aware of before signing or completion, are applied somewhat rarely. It should be noted that representation and warranty insurance policies often include a carve-out from coverage to the extent that the insured has knowledge of the issue before the policy becomes binding, which is often at the completion of the transaction.

US PRE-COMPLETION TAX INDEMNITY

In addition to the tax representations and the corresponding indemnities for their breach, SPAs often include a separate indemnity for the target's taxes for periods (or portions thereof) ending on or before the completion date. Occasionally, if the deal is priced based on the target's accounts as of a certain date, the pre-completion tax indemnity may run through that date. If one is to be included in a deal, a pre-completion tax indemnity will usually be incorporated into the main body of the SPA, rather than being drafted as a standalone document, but generally serves the same purpose as the tax covenant seen in UK transactions (*see "UK tax covenant" above*).

The tax indemnity generally operates to allocate risk between the seller and the buyer by drawing a line between two periods of time (that is, pre-completion and post-completion) and allocating tax liabilities between those two periods. The pre-completion tax indemnity will provide that tax liabilities arising from events occurring during a pre-completion period (or a portion of it) will be borne by the seller, whereas tax liabilities arising from events occurring during a post-completion period will be borne by the buyer (*see box "Scope of US pre-completion tax indemnity"*).

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US INDEMNIFICATION PROVISION

Unlike in the UK, pre-completion tax indemnities are generally given in favour of each of the buyer, the target(s) and their affiliates.

An indemnification provision provides the applicable procedures with respect to calculating and paying claims under the SPA. Without the indemnification provision, a party would be forced instead to rely on a general claim for breach of contract. If included in the SPA, an indemnification provision will typically relate to other provisions in the SPA, including the representations and covenants. Materiality qualifiers are often disregarded for purposes of determining whether a representation has been breached and for purposes of computing damages.

As with all provisions of an SPA, the inclusion of an indemnification provision will depend on the particular circumstances of the deal. If the target is being sold by the founder (or management), the parties will often agree to an indemnity because the buyer is at a significant information disadvantage relative to the seller, and the seller is better equipped to bear the risk relating to pre-completion taxes. However, where the target is a public company, or private equity-backed, the transaction will often proceed without an indemnity or, in the case of a private equity seller, with a limited indemnity.

Limitations and exclusions

The indemnification provision may be subject to certain restrictions and limitations, including the following:

- A time limit for the buyer to bring a claim under the indemnity. With respect to taxes, the indemnification provision will often survive for the full statutory limitation period.

- A deductible limitation, which provides that the seller will only be liable to the extent that a claim exceeds a specified amount, and a threshold or basket, which provides that the seller will be liable for the full amount of damages but only if they exceed a specified amount. An indemnity with respect to taxes will almost never be subject to a deductible or threshold limitation; however, it is often subject to a cap (often at full purchase price, but occasionally at a smaller amount).

Other limitations on the indemnity typically include liabilities included in the computation of the purchase price; for example, in debt or working capital. In addition, the damages computation is often calculated net of any tax benefits realised by the buyer or its affiliates in connection with the loss that gives rise to the claim. However, given that these tax benefits may often be realised following the payment of an indemnification claim, the parties often negotiate only to account for tax benefits received within a limited time period or to discount the indemnification payment by the net present value of the tax benefits computed formulaically using negotiated assumptions.

Scope of US pre-completion tax indemnities

If included in the SPA, the pre-completion tax indemnity will often cover, among other things, tax liabilities of the target (including its subsidiaries) that are imposed:

- In respect of taxable periods (or portions of them) ending on or before the completion date.

- On the target by reason of having been a member of an affiliated, combined, consolidated or unitary group.

- On any person for which the target is, or has been, liable by contract or assumption, as a transferee or successor or otherwise.

Other indemnities may be necessary depending on the target's ownership, the nature of the target's business, the types of assets held by the target and, most importantly, any other matters arising from due diligence or during the disclosure process.

US TAX MATTERS SECTION

An SPA with an indemnification provision will generally include a tax matters section, which provides post-completion covenants regarding tax return filing, the conduct of tax controversies and other matters.

The tax matters section will often include a provision allocating transfer taxes. In non-real estate US deals, transfer taxes are often nominal so the parties frequently agree to split them to incentivise both parties to co-operate to structure their affairs to minimise these taxes. US market practice is mixed on who bears these taxes when they are more than immaterial. In the UK, however, transfer taxes are generally borne by the buyer.

Conduct of tax affairs and tax claims

Like in the UK, it is important to stipulate how any tax returns relating to pre-completion periods (or portions of them) that are due post-completion will be dealt with between the buyer and the seller. The seller is often very interested in these returns where there is a pre-completion tax indemnity as it is accountable for the tax liabilities relating to them but, without express contractual rights, does not have any oversight on their preparation.

It is typical for the SPA to contain a covenant that any such tax returns are prepared in a manner consistent with the past practice of the target, unless otherwise required by applicable law. However, market practice is rather mixed on which party has the right to prepare these returns and the level of review that the other party has in respect of their preparation.

The conduct of tax claims, and who controls these matters, will also be a matter for negotiation. If the SPA has an indemnity for pre-completion taxes, the seller will seek control of tax audits relating to pre-completion periods. However, buyers are often reluctant to relinquish control of tax audits to sellers, even when the sellers are fully accountable for any liability arising out of the audit.

The conduct of claims provisions will set out the respective rights and obligations of the parties, including:

- How and when the other party must be notified.

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- Which party will have control of any dispute or negotiations with the relevant tax authority.

- The extent to which the non-controlling party may be involved in the tax claim.

- Whether the non-controlling party has consent rights with respect to any settlement or resolution of the tax claim.

Tax refunds

It is customary, where the seller provides a pre-completion tax indemnity, for the seller to be entitled to receive any tax refunds received by the target company in respect of taxable periods (or portions of them) ending on or before the completion date. To prevent double counting, the seller would normally not be entitled to any such refunds to the extent that they were included as assets in the computation of the purchase price. In addition, the buyer is often entitled to net from these amounts the costs and expenses (including taxes) incurred in connection with their receipt.

In recent transactions in the US, sellers are pushing to require buyers to pay separately for the value of transaction tax benefits; that is, the tax deductions that arise as a result of the transaction. The items that generally make up these deductions include compensation payments (including options spread) relating to the deal, deferred financing costs and professional fees.

While sellers uniformly push to have buyers pay for these items at completion (often with a net present value component to the computation, to account for the fact that these companies are often not cash taxpayers), buyers are often successful at either accounting for these items in the "top line" purchase price, or paying for the tax benefits as and when received.

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