



# Tax Deeds of Indemnities: Issues to Consider

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## 1. Introduction

In the commercially litigious environment that currently exists, the issue of taxation in the context of share acquisitions is one of paramount importance and requires careful and ongoing discussion between the client, taxation advisers and solicitors in order to ensure that tax issues are properly documented and indemnified (if required). The main avenue for comfort as regards any pre-completion tax issue that may exist in the target company is to seek a tax deed of indemnity pursuant to which the sellers or some of them (generally described as the covenants) indemnify the buyers (subject to

certain caveats and exceptions) against certain tax liabilities of the target company which relate to a pre-completion period.

The particular issues in need of consideration will generally come to light during the course of the taxation due diligence.

## 2. Due Diligence

The issues to consider in the context of taxation due diligence would justify an article in itself. However, in broad terms, the main and primary purpose of the taxation due diligence is to identify any possible exposure to taxation

liability and protect against any such exposure by any or all of the following:

- a) a reduction in the price;
- b) a retention from the price by way of withholding payment – for example, by way of an escrow amount which would be withheld until the tax issue has been resolved definitively;
- c) seeking the appropriate warranties/ indemnities; and/or
- d) considering “acceptable” tax disclosures in the context of the disclosure letter.

The results of the taxation due diligence will ultimately drive the commercial imperatives that will underline the negotiation of the tax deed of indemnity.

### 3. What is a Tax Deed of Indemnity?

A number of phrases are used interchangeably when describing the method by which the sellers (covenantors) indemnify the buyer in respect of the pre-completion liabilities of the target company. In an English Law document the documents can be described as “tax covenant” or “tax schedule” and are generally included as a schedule to the share purchase agreement. In an Irish context, tax covenants are, in certain circumstances, used in share purchase agreements reflecting smaller share purchases. However, it is more standard in an Irish Law context to see a stand-alone tax deed of indemnity and this is the type of document that will be considered further here.

The tax deed of indemnity seeks to allocate risk (subject to certain specified exceptions) between the sellers and the buyer, whether referable to completion or the date of the last audited accounts, with the broad principle being that any tax other than tax which has been provided for in the last statutory audited accounts or which arises in the ordinary course of the target company’s business since the date of the statutory accounts, shall be for the account of the sellers.

By way of background, an indemnity is a contract to protect someone against loss (the loss being the hypothetical tax charge). The difference between an indemnity and a guarantee is that an indemnity is a separate enforceable contract while a guarantee is only enforceable (unless otherwise stated) where there is a default or

mis carriage of a primary obligation (such as an obligation to pay debt, for example).

Taxation tends to be the main issue that buyers seek protection from; hence warranties and a deed of indemnity may be required. The buyer will find that a claim based on an indemnity will be easier to prove than one for breach of warranty.

A warranty is a contractual assurance that takes the form of statements of fact from the sellers (or the warrantors) as to the target company’s business, profitability, and assets and liabilities, for example. An indemnity is designed to save the indemnified party from a specific loss and that party will be under no obligation to prove that the shares in the target company are devalued in any way due to the event giving rise to the indemnity claim, which is the case in the context of a warranty claim.

### 4. Form of Tax Deeds

The background of tax deeds can arguably be traced back to s46 of the UK Finance Act 1940, which allowed estate duty to be levied on a company on the death of a person who had, during his or her lifetime, transferred property to the company. This created the unfortunate situation that the company could be held liable to an estate duty with no right to recover it (whether statutory or otherwise). A subsequent UK Income Tax Act (1952) also created a deemed charge for tax (a surtax) if the company in question did not pay a “full dividend” during the relevant taxation period. Again, there was no right of recovery for the company in respect of this surtax charge.

The form of tax deeds has historically been by way of an indemnity whereby the sellers would indemnify the target company regarding this secondary liability and the document ultimately

expanded over the course of time to cover all liability to be borne by the target company. However, this practice is now rarely seen following the case of *Zim Properties Limited*.<sup>1</sup>

Although the case did not actually involve a tax deed, it is taken as authority that any claim made by the target company under such a deed would be treated in the same way as the plaintiff’s claim therein and, consequently,

the target company would be fully taxable on the receipt.

Zim Properties Limited, the taxpaying company, had contracted to sell some of its properties. Completion was to take place 12 months later and time was to be of the essence to the contract. Zim was unable to produce a conveyance and hence unable to show good title – due, as it claimed, to the negligence of its solicitors. The proposed buyer repudiated the contract, as it was entitled to do, and Zim issued a writ against its solicitors claiming damages totalling £104,138 (being the difference between the agreed price in the repudiated contract and the monies actually received when the sale finally went through). The action was then settled with the solicitors agreeing to pay Zim a total of £69,000.

The result of the decision means that any payment made to the target company by virtue of a tax deed would be assessable to corporation tax without any deduction. To compensate the

## The tax deed of indemnity seeks to allocate risk between the sellers and the buyer, whether referable to completion or the date of the last audited accounts.

1. *Zim Properties Ltd v Proctor* (Inspector of Taxes) [1985] STC 90

target for this loss, the seller of the target's shares would be required to gross-up any payment under the deed, but this extra financial burden on the seller is likely to be opposed in most cases. In addition, the seller would receive no tax relief for the indemnity payments made to the target.

The common sense approach, which is generally adopted, is to maintain the tax deed as a deed between the seller and buyer of the shares in the target. As a result, a payment to the buyer, as opposed to the target company, will be treated by Revenue as a reduction in the consideration receivable by the seller and that payable by the buyer. As this lowers the purchase price of the shares it will also decrease the seller's capital gains liability. Furthermore, there will be no immediate negative tax implication for the buyer. It does remain common practice, however, to insist on the inclusion of a clause in the tax deed relating to gross-up payments in the event that Revenue should choose to challenge the former suggestion.

The above does not mean that the target company should not be party to the tax deed as the target company may need to be party to the tax deed in order to undertake certain obligations, such as the provision of information in respect of any future Revenue claim.

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## 5. Major Provisions in Tax Deeds

### 5.1 Covenant to pay

A covenant to pay makes the sellers liable to pay an amount equal to the tax charge levied on the target company. The amount is limited to the amount of the tax liability, as the commercial

basis of the tax deed is that, if the company is put back into the position it was in prior to the claim, there is no loss.

An example of a form of tax covenant would be as follows:

*The Seller covenants with the Buyer and (as separate covenants) with the Company that, subject to the following provisions of this deed, the Seller, as directed by the Buyer, pay to the Buyer an amount equal to taxation of the Company resulting from or by reference to any income, profits or gains earned, accrued or received on or before the date hereof.*

The tax liability should be payable under the tax deed whether or not the target company can claim reimbursement from a third party on the basis that the buyer should be in a position to seek immediate recompense from the seller, regardless of whether the claim arises through the fault of another person. This is the major difference between a warranty claim and an indemnity claim.

In summary, a payment will generally be required pursuant to the tax covenant in the following circumstances:

- › when an unexpected liability (or loss of an expected relief, for example) results in a payment of tax;
- › when an expected repayment from the Revenue Commissioners is not received;
- › when a requirement to pay tax occurs, which would have been avoided if an expected relief had not been withdrawn – this type of relief is generally known as a **Seller's Relief** for the purposes of the tax deed; and
- › when a payment of tax would have occurred but for the availability of other reliefs (i.e., the use of relief available to the buyer/buyers and commonly defined as a **Buyer's Relief** for the purposes of the tax deed).

The mechanism for payment is usually triggered by the target company receiving a Revenue Commissioners' notice of assessment. From a buyer's perspective, it should be ensured that any payment obligations under the tax deed will be triggered prior to any payment obligation of the target company to the Revenue Commissioners.

### 5.2 What liability is covered or should be covered by the tax deed of indemnity?

There are two basic methods of approaching a tax covenant:

- (i) the first, and somewhat less common method of structuring a tax deed, is to provide for a covenant to pay an amount equal to taxation arising on actual or deemed profits, income or gains accruing on or before completion (being completion of the acquisition of the shares in the target company); and
- (ii) the second, and more frequent method of structuring a tax deed, is to first split the

pre-completion period into the period up to the date of the last audited accounts of the target company and, secondly, the period between the date of the last audited accounts and completion. The covenant, in respect of the period from the date of the last audited accounts up to completion, covers taxation arising outside of the **ordinary course of business**.

This means that it becomes an important part of the drafting process to precisely define and agree what is a matter, event or circumstance (an Event) which is outside of the **ordinary course of business** of the target company. This means that if an unforeseen and/or unusual event or circumstance comes to light post-completion, during the accounting period following the accounts date, and/or up to completion, which results in a tax liability falling on the target company, then the sellers shall covenant to pay to the buyers any amount in respect of that tax liability. Following on from that point, any tax reliefs due to the target company after the last accounts date should be for the account of the target company (under the ownership of the buyer).

### 5.3 Exclusions to liability

This provision will be of paramount importance from a seller's perspective as it provides for a set list of circumstances, which if any of them occur, then, notwithstanding that a tax liability of the target company does exist, no liability arises for the sellers pursuant to the tax deed. Obviously, if acting on behalf of the buyer, the preference is to seek as limited a list of exclusions as possible.

Examples of some exceptions include:

- (i) taxation arising from the ordinary course of business from the date of the

- last statutory audited accounts up to completion;
- (ii) where the liability was reflected with a provision or reserve in the last audited accounts or the management accounts of the target company provided up to completion (the completion accounts). This is a particularly valuable exclusion if completion accounts are agreed between the parties as completion accounts should provide for taxation in the same manner as statutory audited accounts;
- (iii) where the liability was caused by a voluntary act or transaction implemented at the buyer's behest;
- (iv) an exclusion, in respect of pre-completion restructure and/or reorganisation of the target company or its group companies carried out at the behest of the buyer, might be considered;
- (v) failure of the buyer to make an election to the Revenue Commissioners;
- (vi) a post-completion cessation of the group structure of which the target company might be a member; or
- (vii) if the charge to tax arises as a result of any change in the accounting policy of the target company implemented by the buyer post-completion.

### 5.4 Cap or limitation on liability

This is generally an issue of contention and there is no set process. Certain sellers' advisors can seek to cap the liability of the seller pursuant to

the deed to such an amount as equates to the consideration actually paid. When considering this from a buyer's perspective, you need to be careful to ensure that when agreeing to any such consideration cap, you include in the computation any liabilities assumed by your client as part of the share acquisition or promoter loans repaid, for example, as part of the global deal.

In addition, when acting on behalf of a seller, it would be important for the purposes of capping the consideration to cap liability at the amount of the consideration actually paid to the sellers for the purposes of the tax deed rather than the maximum consideration which could be paid to the sellers (subject to achievement of earn-out targets, etc).

The parties may also seek to agree a *de minimis* claim level below which the seller would not

seek to make a claim pursuant to the tax deed. Some parties take a view that no *de minimis* should be considered in the tax deed as the liability of the sellers pursuant to the tax deed is, in essence, an on demand liability that would not require the lengthy contractual process sometimes involved in processing a warranty claim.

**It is also important to include negligence as an event that would result in the time limitation period being set aside as the Revenue Commissioners have the ability in the event of negligence on the part of the taxpayer to set aside the specified time limits.**

The time limitation regarding a tax deed, in a tax covenant/schedule governed by the laws of England and Wales can be upwards of seven years. However, it is generally accepted that a period of five years is acceptable in the context

of an Irish Law tax deed. It is important to remember, in the context of agreeing to any such time limitation, that the specified limitation period should be set aside as a result of the wilful misconduct and/or wilful concealment of the seller company and/or its directors. It is also important to include negligence as an event that would result in the time limitation period being set aside as the Revenue Commissioners have the ability in the event of negligence on the part of the taxpayer to set aside the specified time limits as set out in the Taxes Consolidation Act 1997.

### 5.5 Conduct of claims

The provision in the tax deed that generally arouses the greatest level of discussion is the conduct of claims provision pursuant to which the parties agree who should be entitled to carry forward an appeal or dispute of a Revenue claim post-completion.

From a seller's perspective, the view could be taken that the buyers may not put their heart and soul into defending a Revenue claim when they are safe in the knowledge that they are 100% indemnified by the sellers for the Revenue claim pursuant to the tax deed and/or they have an escrow fund available to satisfy any such liability.

From a buyer's perspective, they will not wish to allow the "ownership" of the Revenue dispute to be ceded to the seller and thereby possibly

jeopardise the target company's relationship with the Revenue Commissioners.

The issue needs to be considered on a transaction-by-transaction basis. However, a happy medium can be struck in certain circumstances from a seller's perspective on the basis that, if:

- (i) the seller provides a full and unconditional indemnity in favour of the buyer in relation to the Revenue appeal application; and
- (ii) provides suitable confidentiality agreements/obligations,

then the seller may be permitted to have conduct of the Revenue appeal claim, subject to keeping the buyer informed at all stages of the appeal process. Certain issues might need the specific

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consent of the buyer such as the appointment of legal advisers, settlement of the claim and the forwarding of written responses to the Revenue Commissioners. In certain scenarios, the buyer will wish to provide that the seller would not be entitled to assume conduct of a claim in the event that their legitimate commercial interests could be jeopardised or where the assumption of the claim by the seller could have an adverse impact on the business reputation of the buyer group (including, for example, its relationship with the Revenue Commissioners). In such a circumstance, the buyer would be required to

consult with the seller in relation to the Revenue application on an ongoing basis.

### 5.6 Over-provisions

Over-provision clauses are now almost standard practice. These clauses seek to govern a scenario whereby there may have been an overprovision for taxation in the last audited accounts of the target company. The way to govern this issue is to generally provide that there would either be a set-off of the over-provision against another liability of the sellers pursuant to the tax deed or else a straight cash repayment to the seller. From a buyer's perspective, it could be argued whether the seller should be protected against its own mistake of over-providing for taxation. However, it is a relatively common practice that a provision along these lines is included in the tax deed.

### 5.7 Assignment provisions

The buyer may want the contractual ability to assign the benefit of the tax deed without the consent of the sellers and this issue becomes of greater importance where the purchase of the shares may be funded by a third party financial institution which will want the ability to take an assignment of the benefit of the tax deed for the purposes of enforcement, should the debtor company default on loans, etc. This is quite difficult to resist from a seller's perspective. However, if the wording of the assignment is to be accepted it could be provided that any assignment pursuant to the deed should not have the effect of increasing the liability of the warrantors or the covenantors.

## 6. What Other Issues Need to be Considered?

### 6.1 Pre-sale reorganisations

There can, in certain circumstances, be a reorganisation and/or restructuring carried out in relation to the target company/group prior to completion. From a buyer's perspective, it would

be important to ensure that a specific clause is included in the tax deed covering any liability arising out of the reorganisation. It would be an important part of the tax due diligence process to identify the tax issues arising from any such reorganisation in order to precisely identify the tax risks.

From a seller's perspective, it is imperative that the "Reorganisation" is precisely defined – however, the sellers will want to resist this as it sets out the details of the reorganisation in a document which may at any time fall into the hands of the Revenue Commissioners.

If the reorganisation was carried out with the knowledge of and even at the specific request of the buyers where, for example, the buyer did not wish to acquire property interest(s) held by the target company or where the buyer did not wish to acquire a subsidiary company which solely holds property interests, then the sellers might seek to carve the tax effects of this reorganisation out from the terms of the tax deed.

## 6.2 Definition of "Taxation" – inclusion of stamp duty

A careful issue to consider is the definition of "Taxation" in the context of the tax deed due to a theoretical issue of contention, which might arise on the basis of section 131 of the Stamp Duties Consolidation Act 1999. Section 131 of the Stamp Duties Consolidation Act 1999 provides that any contract which seeks or purports to indemnify a party in respect of its liability to stamp duty shall be void. Following on from that, a view (albeit a conservative one) could be taken that to include stamp duty (which is technically incapable of being indemnified pursuant to section 131) in the definition of "Taxation" could taint the deed and, thereby, possibly leave it open to an allegation that the entire deed is void.

The conservative course of action in this regard is to provide that stamp duty would be removed from the definition of "Taxation" and that a separate warranty in respect of stamp duty would be included in the tax deed along the following lines:

*The Vendors warrant to the Buyer that all documents forming part of the title to any asset of the Company or which Company may wish to enforce or produce in evidence are duly stamped and have where appropriate been adjudicated. If this warranty is untrue with respect to any document and in the reasonable opinion of the Buyer it is necessary to procure stamping of such document, then the Vendors shall pay to the Buyer on demand by way of liquidated damages an amount equal to any unpaid stamp duty and any interest or penalties payable in respect thereof.*

## 6.3 Change of tax residence

From a seller's perspective, s629 TCA 1997 – and more particularly sub-section 5 thereof – needs to be considered. The sellers might seek comfort whereby the buyer would agree to indemnify and hold the sellers harmless in respect of any tax it (or any other person falling within s629(4) TCA 1997) incurs or becomes liable to pay, resulting from any action by the buyer, the company or the subsidiary, which results in the residence of the company or its subsidiary being transferred outside Ireland at any time on or after completion and thereby coming within the charge to taxation pursuant to s629 TCA1997.

Section 629 allows the Revenue Commissioners to recover unpaid corporation or capital gains tax from another member of the group of companies that the defaulting non-resident company was a member of at the time the gain was accrued, or from an existing controlling director of the

company or a controlling director at the time the relevant gain was accrued.

## 7. Company with Venture Capital/State Funding

Generally, venture capital investors will not be prepared to give any form of tax indemnity or warranties (save for in respect of title to their shares). This would probably have been a specific condition of the investment by the VC firm/ investor. In addition, in certain circumstances, Enterprise Ireland will not provide a tax indemnity on disposal in respect of an investee company in which it held a shareholding. Needless to say, the buyer will want an indemnity in respect of 100% of the "unexpected" tax liability; therefore, this will mean the indemnifying sellers may have to provide an indemnity that will proportionally represent a greater proportion of the consideration received by them. Say, for example, if two shareholders were 40% shareholders in a company which a non-covenanting VC firm held a 20% shareholding, the indemnifying sellers will then in fact be indemnifying the buyer in respect of 50% of the unexpected tax liabilities of the company.

## Conclusion

Claims under tax deeds are becoming a more regular event and it is imperative that appropriate tax advice allied with appropriate legal advice is provided prior to and at the drafting stage in order to safeguard the sellers or buyers' position (as appropriate). The terms of the tax deed should not be accepted as a *fait accompli*, as each transaction may have specific issues that need specific protection/amendments to be built into the tax deed.