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TAX INDEMNITIES IN SHARE SALE AGREEMENTS:

Can they be simplified?

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CONTENTS

TAX INDEMNITIES IN SHARE SALE AGREEMENTS: CAN THEY BE SIMPLIFIED? 1

INTRODUCTION 1
Purpose of a tax indemnity 1
General law indemnity principles 1
SHORT FORM TAX INDEMNITY 2
Could short-form indemnities be used more widely? 4
Tax benefits relating to pre-completion periods 4
Suggested drafting of a comprehensive short form tax indemnity 5
LONG FORM TAX INDEMNITY 5
Indemnity is for net position 7
Clauses dealing with tax compliance issues post-completion 7
Clauses dealing with timing of payment(s) under tax indemnity 8
Conduct of claims clause 9
LOCKED BOX SITUATIONS 11
TAX TREATMENT OF PAYMENTS BY VENDOR UNDER INDEMNITIES OR WARRANTIES 12

TAX INDEMNITIES IN SHARE SALE AGREEMENTS: CAN THEY BE SIMPLIFIED?

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Introduction

It has become common practice in recent years for the tax indemnity clause in an agreement for the sale and purchase of shares to be long and detailed. The length is typically due to a number of exclusions from the indemnity being specified, as well as provisions regarding how the amount payable under the indemnity is to be calculated. If a detailed clause dealing with the conduct of any tax claims by the revenue authorities is also included, then the tax indemnity and associated clauses can sometimes occupy a disproportionate amount of space in the agreement.

Of course, brevity should not be pursued for its own sake, and the advantage of a prescriptive clause is that it should (if well drafted) leave little room for uncertainty or dispute over its scope and effect. However, in this paper the authors consider whether the "standard" clauses currently being used in the New Zealand market could be simplified without sacrificing much in the way of certainty or risk allocation.

Purpose of a tax indemnity

The purpose of a tax indemnity clause in an agreement for the sale and purchase of shares is to make the vendor liable to the purchaser for tax liabilities of the company that is being sold to the extent such liabilities relate to the period(s) prior to sale. This enables the purchaser to offer a purchase price confident that it will not suffer the burden of any latent tax liability of the target company. In other words, uncertain tax risk does not need to be "priced in" by the purchaser.

For this reason, a tax indemnity is generally triggered on a "dollar-for-dollar" basis and operates as an adjustment to the purchase price of the shares. This reflects the fact that a tax liability that comes to light following completion would, if its existence was known at completion, have resulted in a lower purchase price.

General law indemnity principles

In order to evaluate the merits or otherwise of elements of a tax indemnity it is necessary to consider the legal nature of a contractual indemnity. A core element is that a promise of an indemnity is a promise of exact protection against loss arising from an event or circumstance. This promise of exact protection means that the indemnified party should not be under-protected nor over-protected.

In order to determine the protection to which the indemnified party is entitled under the indemnity it is necessary to have regard to both the loss in fact suffered and any benefits

received by the indemnified party in relation to the loss (including any benefits resulting from the same event that gave rise to the loss). The benefits that are taken into account in this regard need not be received by the indemnified party at the same time as the loss is suffered or prior to payment being made under the indemnity. In *Burnard v Rodocanachi* (1882) 7 App Cas 333 (HL) Lord Blackburn stated (at 339):

> The general rule of law (and it is obvious justice) is that where there is a contract of indemnity ... and a loss happens, anything which reduces or diminishes that loss reduces or diminishes the amount which the indemnifier is bound to pay; and if the indemnifier has already paid it, then, if anything which diminishes the loss comes into the hands of the person to whom he has paid it, it becomes an equity that the person who has already paid the full indemnity is entitled to be recouped by having that amount back.

Another key element of a contractual indemnity is that the amount of loss and the ability of the indemnified party to recover that amount from the indemnifier is not affected by contractual damages principles such as causation, mitigation and remoteness. If a loss is within the scope of the indemnity then that loss may be recovered as a debt, not as damages. Of course the drafting of the indemnity may mean that certain contractual damages principles are effectively incorporated into its scope, to limit it. However, once the scope has been ascertained as a matter of contract interpretation, if a loss falls within that scope, then the indemnity applies to the amount of the loss.

An interesting area is where a claim is made under an indemnity by reference to a settlement of a third party claim by the indemnified party, the settlement amount being the "loss" claimed under the indemnity. In order to make such a claim without proving an actual liability to the third party, it appears necessary for the indemnified party to show that the settlement was reasonable (see, for example, *Biggin & Co Ltd v Permanite Ltd* [1951] 2 K.B. 314 and *Codemasters Software Co Ltd v Automobile Club de L'Ouest* [2009] EWHC 2361). Whether the settlement was reasonable has two aspects: was it reasonable in the circumstances to settle; and was the sum fixed by the settlement reasonable?

It is possible that tax indemnity claims based on a settlement with the tax authorities could in many cases be distinguished from indemnity claims based on other forms of settlement. That is because in many cases settlement of tax disputes will occur following an assessment by the Commissioner, thereby establishing an actual liability, and even when that is not the case (eg where a settlement is reached at the NOPA/NOR stage), an assessment will be issued following, and which reflects, the terms of the settlement, again giving rise to an actual liability. However, at least in the latter case, the same could arguably be said for settlement agreements in respect of commercial disputes; that they give rise to an actual legal liability to pay the settlement sum.

Short form tax indemnity

There are a number of examples of short form tax indemnities used in the market. In the New Zealand market these are generally used in low value transactions or where the company being sold does not have complex tax affairs. However, they are not uncommon in large transactions in the US for example. The authors consider that they could be used far more widely in New Zealand without significantly reducing certainty for the purchaser or the vendor. An example is as follows:

Tax indemnity

The Vendor indemnifies the Purchaser and undertakes to keep the Purchaser at all times fully and effectively indemnified from and against any Tax of or otherwise imposed on the Company, to the extent that the Tax:

- relates to any period or part period ending on or before the Completion Date; or
- would not have occurred but for a breach of a Tax Warranty -
- and is not taken into account in the calculation of the provision for Tax in the Completion Accounts.

The essence of the above clause is simple: if there is a tax liability relating to the period to completion, or following completion as a result of a breach of a tax warranty, and the liability was not factored into the purchase price by being included as part of the tax provision in the completion accounts, then the vendor is liable to the purchaser for an amount equal to the tax liability.

A suggested definition of "tax" is as follows:

> *Tax* means:
>
> - all forms of taxation, withholding, duty, imposts, levies, rates and other statutory, governmental or local governmental impositions of whatever nature;
> - interest, penalties or fines relating to or arising in connection with the imposition of, or late, under or non-payment of, any such tax.

It is suggested that in most cases only the following tax warranties would be required in order to cover off tax liabilities that relate to post-completion periods (and so would not be covered by the first limit of the tax indemnity) for which the vendor should be liable:

> *Tax Relief*
>
> Any Relief taken into account in the calculation of the provision for Tax in the Completion Accounts will, after Completion, be available to be refunded or credited against any Tax that may be payable after Completion.
>
> *Imputation Credit Account*
>
> The Company's imputation credit account has been correctly maintained as required and will not have a debit balance on the Completion Date which will or could give rise to a Tax liability to the Company.

A suggested definition of "Relief" is as follows:

> *Relief* means any credit or rebate taken into account in computing any Tax liability or any right to refund or repayment of Tax (whether or not including interest or penalties).

The purpose of the first warranty (relating to Tax Relief) is to ensure that the purchaser will be able to claim against the vendor in the event that the provision for tax in the completion accounts was reduced (such that the purchase price was increased) on account of relief that was not in fact able to be monetised by the purchaser (either by way of refund or reduction of tax in fact payable) following completion. The authors consider that the use of this warranty is preferable to including “loss of Relief” in the definition of Tax, as the latter approach, without a specific exclusion, has the effect that the purchaser will be indemnified for tax losses (if included in the definition of Relief) and other credits eliminated on completion. Tax losses are not included in the definition of Relief above, because they will not be available to be refunded or credited after Completion. The purpose of the second

warranty is to ensure that any tax liability that results from a debit balance in the imputation credit account on completion (which will be payable after completion if the imputation credit account is not put into credit by the next 31 March, and so would not be covered by the first limb of the tax indemnity) is recoverable from the vendor.

If there are specific risks or concerns relating to the company and/or its assets that may materialise as post-completion tax liabilities, they could be dealt with through additional warranties. An example could be where there is some uncertainty regarding whether land owned by the company is on revenue account.

Could short-form indemnities be used more widely?

The question that then arises is whether a short form tax indemnity of the type set out above could also be used for more complex or high value transactions. The broad principle remains the same in such transactions: tax liabilities relating to pre-completion periods remain with the vendor (and so fall within the scope of the indemnity) whereas tax liabilities relating to post-completion periods (like post-completion profits) are for the purchaser's account.

As noted above, a core element of an indemnity is the concept of exact protection. This means that many limitations that are often included in order to ensure the purchaser is not over-compensated are unnecessary. These could include limitations based on:

- relief being available to reduce or satisfy the tax liability;
- the liability for tax in one period being offset by a reduction of tax in another period (ie timing differences);
- the tax liability relating to an amount of income or an asset that was not taken into account in the completion accounts.

Other limitations often included in long form tax indemnities relate to actions or conduct of the purchaser, for example where the tax liability results from:

- a failure by the purchaser to make a claim or election or give a notice;
- a voluntary change in accounting principles or tax treatment of any item or a change in balance date;
- the purchaser or company requesting an amendment to an assessment or return.

Because indemnity claims are not naturally limited by factors such as causation and mitigation (as noted above) it is in a vendor's interests to do so through the drafting. Arguably a general limitation referring to liabilities caused or increased by acts, omissions or conduct of the purchaser would be adequate (although possibly lacks certainty and could be resisted by the purchaser on that basis).

Tax benefits relating to pre-completion periods

Another question that arises is how any tax benefits received by the company relating to the pre-completion period that were not factored into the purchase price are dealt with. An example of such a benefit is where the purchaser notices an error in a pre-completion tax return and, as a result of a request under s 113 of the Tax Administration Act 1994, the company receives a refund.

Often there will be a "net benefit" clause as part of the tax indemnity, meaning that any pre-completion benefits not factored into the purchase price will reduce the vendor's liability under the tax indemnity in the event of any claim. In some cases the purchaser will be required to disgorge the value of any excess, including where no claim has been made under the indemnity. This is a truly symmetrical indemnity and can be justified on the basis that if the purchase price has been agreed on the basis that the company's net tax liability is accurately reflected in the completion accounts, there should be a reciprocal obligation to adjust the purchase price up or down in the event that the net tax position was in fact different.

Suggested drafting of a comprehensive short form tax indemnity

Reflecting the discussion above it is suggested that a "short form" tax indemnity that could be used in high value or complex transactions could be as follows:

> *Tax indemnity*
>
> The Vendor indemnifies the Purchaser and undertakes to keep the Purchaser at all times fully and effectively indemnified from and against any Tax of or otherwise imposed on the Company, to the extent that the Tax:
>
> - relates to any period or part period ending on or before the Completion Date; or
> - would not have occurred but for a breach of a Tax Warranty -
>
> unless and to the extent that the Tax:
>
> - was taken into account in the calculation of the provision for Tax in the Completion Accounts; or
> - would not have arisen but for an act or omission of the Purchaser or the Company following Completion, unless required by law or which occurred with the prior written consent of the Vendor; or
>
> results from a change in law announced after the date of this agreement.
>
> *Tax reductions*
>
> If the Company has a reduction in its liability for Tax in respect of a period ending on or before the Completion Date with the effect that the Company has made an overpayment of Tax or has overprovided for Tax in the Completion Accounts, and that reduction in liability results in a refund of Tax or a reduction in Tax payable after the Completion Date, the Purchaser shall pay the amount of that reduction to the Vendor.
>
> *Adjustment to purchase price*
>
> Any amount payable under clauses [ ][refer to tax indemnity and tax reductions clause] shall be paid by way of an adjustment to the Purchase Price.

Long form tax indemnity

Where the preference is to use a long form indemnity, a suggested clause is set out below**.** Rather than potentially add to the length of the clause with “purchaser favourable” or “vendor favourable” additions or subtractions, the clause below is a balanced one which is likely to be reasonable to both purchaser and vendor except in particularly complex transactions.

Tax indemnity

The Vendor indemnifies the Purchaser and undertakes to keep the Purchaser at all times fully and effectively indemnified from and against any Tax of or otherwise imposed on the Company, to the extent that the Tax:

- Arising before completion date
  - wholly or partly (in which case the liability of the vendor is limited to that part) relates to any period or part period ending on or before the Completion Date; or
- Event before completion date
  - is wholly or partly (in which case the liability of the vendor is limited to that part) attributable to any Event occurring or situation existing (or deemed by law to occur or exist) on or before the Completion Date; or
- Breach of tax warranty
  - would not have occurred but for a breach of a Tax Warranty.

Limitations on Tax indemnity

The Vendor is not required to meet any claim under the Tax Indemnity to the extent that:

- Tax paid or provided for:
  - the Tax has been met on or before Completion or specific reserve or provision (excluding any deferred Tax liabilities established to reflect differences between accounting and tax income) is made for that Tax liability in the Completion Accounts as evidenced by relevant work papers or books of account;
- Failure to make election:
  - the Tax would not have arisen, or would have been reduced or eliminated, but for a failure or omission on the part of the Purchaser or the Company after Completion to make a claim or election or to give any notice or consent the making or giving of which was notified in writing to the Purchaser prior to Completion;
- Tax saving:
  - the Purchaser or the Company makes, will make, or has made a Tax Saving in relation to the matters giving rise to the claim under the Tax Indemnity;
- Other saving:
  - the Tax relates to an amount of income or an asset that was not taken into account in the Completion Accounts and that income or the value of the asset exceeds the Tax payable in respect of that income or asset;
- Timing difference:
  - an increased liability for Tax in one period is or will be offset by a reduced liability for taxation in another period;
- Change in law after the date of this agreement:
  - it arises as a result of any change in law, including any increase in rates of taxation, announced after the date of this Agreement;

- Change in accounting principles or taxation treatment:
  - the Tax liability arises or is increased as a result of any voluntary change in accounting principles or in the treatment of any item for Tax purposes made by the Company after Completion;
- Amended return:
  - the Company amends or requests an amendment to any return filed prior to Completion by the Company with the IRD or other relevant Tax Authority unless the amendment is required by law and the Vendor consents to the amendment, which amendment will not be unreasonably withheld.

Indemnity is for net position

The Vendor's aggregate liability under the Tax Indemnity is limited to the net, overall, Tax liability incurred which arises in the circumstances referred to in clauses [ ] to [ ] [the three limbs of the tax indemnity]. If the Vendor has paid any amounts under the Tax Indemnity and, by [the end of the tax indemnity claims period] the Company has had reductions in its Tax liability for the period prior to Completion which have not previously been taken into account in this clause, the Purchaser will repay to the Vendor an amount equal to the lesser of:

- the reduction in its Tax liability for the period prior to Completion; and
- the total amounts paid by the Vendor under the Tax Indemnity.

The second limb of the tax indemnity (dealing with Events occurring or situations expiring) can give rise to uncertainty and consequently be contentious. For example, if the company acquires land pre-completion at a time it is associated with a developer with a consequence that the land is held on revenue account, is a tax liability arising to the company on the sale of the land post-completion "wholly or partly attributable to the event occurring or situation existing before the Completion Date"? Given this uncertainty it is not unreasonable for a vendor to seek the removal of that clause with the consequential addition of specific warranties to deal with concerns of the purchaser.

Note that the "net position" clause set out above does not extend to a fully symmetrical position achieved by the "tax reductions" clause in the short form indemnity. The tax reductions clause could be incorporated if desired by a vendor.

Clauses dealing with tax compliance issues post-completion

Larger and more complex transactions may necessitate documenting how the tax compliance function will operate and be controlled pre- and post-completion. An example is set out below.

> *Filing of returns*
>
> The Vendor will prepare, sign and file Tax returns and Tax computations for the Company for all Tax periods ending on or prior to the Completion Date (Returns), to the extent that those Returns have not been prepared before the Completion Date. The Returns must be filed in time to comply with the Company's obligation under relevant Tax Legislation.

Access to records for returns or disputes

Where the Returns have not been filed prior to the Completion Date, the Vendor may request the Company to prepare or assist with preparing documentation and deal with matters relating to the Returns. The Purchaser must procure that the Company gives reasonable access to its books, accounts, records and personnel as is reasonable to enable the Vendor or its duly authorised agents to prepare the Returns and conduct matters relating to the Returns or to any dispute of a Tax Claim. If the Company is required to prepare documentation relating to the Returns, the Purchaser must procure that copies of all documentation (including, without limitation, relevant correspondence) will be shown in advance to, and agreed with, the Vendor.

Returns for completion year end

The Purchaser must procure that the Company, in relation to the Tax returns for the income year or other period in which Completion occurs (Completion Year Returns), discloses to the Vendor and uses its best endeavours to agree with the Vendor any variations in the information in those Tax returns that would give rise to any change in the Tax liability from that shown in the Completion Accounts. Where there is any disagreement between the Purchaser and the Vendor as to the form and content of the Completion Year Returns the Vendor will determine the form and content of the Completion Year Returns for the period prior to Completion and the Purchaser will determine the form and content of the Completion Year Returns for the period after Completion.

Part year accounts

If so requested by the Vendor, the Purchaser shall procure that the Company, in consultation with the Vendor or its agents, prepares adequate part year accounts for the purpose of the Income Tax Act and use its best endeavours to agree those accounts with the Vendor or its agents.

Where there may be disagreement between the parties (for example, in the preparation of tax returns), it is assumed that there will be a general dispute resolution clause in the agreement which can also apply to tax matters. This should be confirmed.

Clauses dealing with timing of payment(s) under tax indemnity

The clause below is drafted on the assumption that the vendor should pay the amount of the tax liability to the purchaser in time for the purchaser to make a timely payment to Inland Revenue (or immediately if the due date has passed).

Vendor's obligation to pay

Any payment the Vendor is required to make in relation to any claim under the Tax Indemnity:

- Three days before due date:
    - must, where the payment relates to a Tax liability not yet due and payable, be made at least three Business Days before the last date on which payment of the relevant liability may be made by the Company to the relevant Tax Authority without incurring any liability to pay any penalty; and
- On demand:
    - otherwise must be paid to the Purchaser three days following demand being made by the Purchaser and if it relates to clause [Expenses clause] on the Vendor being satisfied as to the basis on which the claim has been calculated in accordance with that clause.

Conduct of claims clause

There will generally be a "conduct of claims" in the agreement for non-tax warranty and indemnity claims. For low value transactions or target companies without complex tax affairs, that may be sufficient to cover tax claims. However, in more complex cases, the parties may wish to have a specific clause in the tax indemnity as set out below. One key issue for a purchaser is likely to be whether it is agreeable to the vendor controlling litigation involving a company which is by then owned by the purchaser. A key issue for the vendor is likely to be whether it is agreeable to the purchaser controlling a dispute the costs of which are born by the vendor.

> *Dispute of Tax Claim*
>
> If the Company receives a Tax Claim which may give rise to a claim under the Tax Indemnity against the Vendor, the Purchaser must give notice of that Tax Claim to the Vendor in writing promptly after receipt by the company of the Tax Claim. The Purchaser must ensure that:
>
> - No prejudice to defence:
>   - no payment (except to the extent required by law) or admission of liability in relation to the Tax Claim is made or other steps are taken which may in any way prejudice any challenge of that claim without the prior written consent of the Vendor which consent will not be unreasonably withheld or delayed; and
> - Challenge of Tax Claim by Vendor:
>   - it permits the Vendor, in the name of the Company:
>   - pending receipt of Counsel's opinion referred to in clause [next clause below] to engage in the disputes procedures contained in Part IVA of the TAA or any similar proceedings (disputes resolution procedures), whether initiated by the relevant Tax Authority or the Vendor in the name of the Company;
>   - to refer the matter to an advisor (Counsel) nominated by the Vendor and approved by the Purchaser (such approval not to be unreasonably withheld or delayed) and experienced in taxation matters for an opinion on the likelihood of the disputes resolution procedures or subsequent challenge being successful if the Vendor requires such action be taken;
>   - if the opinion of Counsel is that the Company has a reasonably arguable case against the liability, instruct advisors nominated by the Vendor and approved by the Purchaser (such approval not to be unreasonably withheld or delayed) to act and advise in the conduct of all disputes procedures and related correspondence and negotiations. If the opinion of Counsel is that there is no reasonably arguable case the Vendor will not take any further action in disputing the Tax liability;
>   - to prepare and file a challenge to any assessment in court if the opinion of Counsel is that there is a reasonable prospect of the challenge being successful;
>   - if the challenge or an appeal is decided against it, at its option, and subject to a recommendation by Counsel, to appeal the decision to any relevant appellate body.

Refunds of disputed tax

If the disputes resolution procedures, challenge or appeal (in relation to which the Purchaser has previously received a payment under the Tax Indemnity) are ultimately successful in whole or in part and the Company receives any tax credit, refund or reimbursement of costs, the Purchaser or the Company will promptly pay to the Vendor (to the extent that it does not exceed that amount previously paid by the Vendor) an amount equal to the amount of that tax credit, refund or costs together with any interest (net of taxation) which the Purchaser or the Company has received from any Tax Authority on such tax credit or refund.

Consultation

The Vendor will, prior to taking any action, consult with the Purchaser and its professional advisors in relation to the conduct and progress of all disputes resolution procedures, challenges or court proceedings and any related correspondence and negotiations, and keep the Purchaser and its professional advisors fully informed on this progress with copies of all relevant documents, including drafts. The Vendor, following consultation, will take into account all reasonable concerns and issues raised by the Purchaser in all action that is taken by the Vendor following consultation.

Expenses

If a payment under the Tax Indemnity would arise in respect of the Tax Claim if the relevant Tax Authority were successful, all reasonable out of pocket costs and expenses properly incurred by the Purchaser or the Company in connection with any consultation, disputes resolution procedure, challenge or appeal of a Tax Claim will be paid by the Vendor. The Vendor undertakes to the Purchaser that the Vendor will pay to the Purchaser such costs and expenses on receipt of copies of the relevant invoices or other evidence of incurrence of the costs and expenses by the Purchaser or the Company.

The following definitions have been used in the long form tax indemnity clauses:

Event means any action, omission, transaction, [amalgamation of any company into the Company] or any other occurrence, whether actual or deemed, and whether or not the Company is a party to it and includes completion and any Event which is a combination of Events that occur before and after completion;

GST means tax as defined in the relevant GST Act;

GST Act means, in the case of New Zealand, the Goods and Services Tax Act 1985 or in the case of any other country or territory, the relevant law imposing goods and services tax or value added tax in that country or territory;

Income Tax Act means, in the case of New Zealand, the Income Tax Act 2007 or in the case of any other country or territory, the relevant law imposing income tax in that country or territory;

IRD means the Inland Revenue Department;

Relief means any credit or rebate taken into account in computing any Tax liability or any right to refund or repayment of Tax (whether or not including interest or penalties).

TAA means the Tax Administration Act 1994;

Tax means:

- all forms of taxation, withholding, duties, dues, imposts, levies, rates or other statutory, governmental or local governmental impositions of whatever nature, imposed in New Zealand or elsewhere, including income tax, withholding tax, approved issuer levy, fringe benefit tax, stamp duty, GST, gift duty, customs or excise duties, regional or local taxes, municipal taxes and accident compensation levies; and
- all interest, penalties or fines relating to, or arising in connection with, the imposition of non or late or under-payment of any such Tax;

Tax Authority means a Government Authority that is responsible for administering or levying Tax, whether in New Zealand or elsewhere, and in particular (but without limitation), the IRD, the Customs Department, the Accident Compensation Corporation in New Zealand and any overseas bodies with similar functions or powers;

Tax Claim includes any notice, demand, assessment, letter or other document issued, or action taken, by or on behalf of any Tax Authority or other person, whether issued or occurring before or after Completion, whereby the Purchaser or the Company may be, or be sought to be, placed under any or any increased liability to Tax or may be deprived or sought to be deprived of any Relief which might otherwise have been available in each case relating to any period, income arising, or Event occurring, prior to Completion;

Tax Legislation means legislation imposing Tax in the relevant jurisdiction, and in the case of New Zealand includes (but without limitation) the Inland Revenue Acts as defined in s 3 of the TAA;

Tax Indemnity means the indemnity contained in clause [refer to the entire clause that governs the Tax Indemnity and its procedures and not just the subclause that provides the specific indemnity];

Tax Warranties means the Vendor Warranties contained in clause [ ] of Schedule [ ];

Tax Saving, in respect of a loss, liability, cost or expense, means:

- where the amount of a loss, liability, cost or expense suffered or incurred is wholly or partly deductible for income tax purposes, the amount of the deduction to which the relevant person is entitled multiplied by the relevant Taxation rate and is deemed to arise in the same income year as the relevant loss, liability, cost or expense is incurred; and
- the amount of any GST input tax credit or other deduction from output tax to which the relevant person is entitled;

in either case in any past, current or future period.

Which tax warranties are included in an agreement that includes a long form tax indemnity will depend on the same considerations as where a short form tax indemnity is included. It is recommended that the two warranties referred to above in support of the short form indemnity are included. Whether any additional warranties are desirable will depend on the circumstances, and any particular tax risks relevant to the company that would not be covered by the other two limbs of the indemnity.

Locked box situations

A "locked box" transaction is one where the purchaser becomes the "economic owner" of the business operated by the company being acquired from a date (the "locked box date") that is earlier than the completion date. This means that the purchase price is determined by reference to the financial position of the company at the locked box date and any profits (or losses) of the company from that date accrue to the purchaser (and so do not affect the purchase price). In order to protect the position of the purchaser from the locked box date until the completion date, when the purchaser will obtain full legal control of the company, the sale and purchase agreement will contain restrictions on certain transfers of value by the company to the vendor and also the incurrence of certain obligations to third parties. These transfers of value are often referred to as "leakage", and the sale and purchase agreement will usually provide that if they do occur, the purchase price shall be reduced by an equivalent amount. Payments of tax should generally not constitute “leakage” because

they will either be provided for in the locked box date accounts or will relate to the tax liability for the period during which the purchaser is intended to be the economic owner.

The tax indemnity in a locked box transaction will be slightly different to the tax indemnity for a transaction where economic ownership passes at completion. That is because for the period between the locked box date and the completion date the purchaser is entitled to the benefit of the profits, and so should bear the burden of tax on those profits. The relevant provision for tax that is referred to in the tax indemnity (as limiting its scope) will therefore be the provision in the accounts prepared in respect of the locked box date, and the indemnity will be for the liabilities relating to periods ending on or before the locked box date:

> *Tax indemnity*
>
> The Vendor indemnifies the Purchaser and undertakes to keep the Purchaser fully and effectively indemnified from and against any Tax of or otherwise imposed on the Company, to the extent that the Tax:
>
> - relates to any period or part period ending on or before the Locked Box Date; or
> - would not have occurred but for a breach of a Tax Warranty —
>
> unless and to the extent that the Tax
>
> - was taken into account in the calculation of the provision for Tax in the Locked Box Date Accounts.

The purchaser could well argue that they should only bear the burden of "business as usual" taxes during the period between the locked box date and completion, and that if any out of the ordinary tax liabilities arise (for example, due to the general anti-avoidance provisions applying) they should be for the vendor's account. That is because, although the purchaser has economic ownership of, or exposure to, the company from the locked box date, they do not have legal control until completion. If that is the negotiated position then the indemnity should be drafted as applying to taxes up to the completion date, but an additional exclusion should be included where:

> the Tax liability relates to the period from the Locked Box Date Accounts to the Completion Date and relates to income, profits or gains derived, received or arising in the ordinary course of the Company's normal trading activities.

Tax treatment of payments by vendor under indemnities or warranties

Under most agreements the amount of the vendor’s liability under the indemnities and warranties (be they tax or non-tax) is reduced by any “tax saving” available to the relevant target company. A tax saving will include the benefit of any tax deduction.

This is generally more of an issue in respect of non-tax claims (where the payment by the company of the claim being indemnified is deductible to the company) than in respect of tax claims (only in limited circumstances will payments of tax by the company be deductible).

The long-form tax indemnity in this paper specifically includes a “tax saving” provision. The non-tax provisions will generally contain a similar provision (if you are acting for a vendor you should ensure that they do).

Consequently, where the target company suffers a $100 loss which is deductible for tax purposes, the vendor will generally be liable to pay $72 (assuming a 28 percent tax rate).

Section CG 4 of the Income Tax Act applies when:

- a person (the company) is allowed a deduction for expenditure or loss;
- the person derives an amount relating to the expenditure or loss, whether through insurance, indemnity, or otherwise; and
- the amount, to the extent of the deduction, is not income of the person under any other provision of the Act.

Where s CG 4 applies, the amount derived is, to the extent of the deduction, income of the person.

Continuing the above example, if the $72 payable by the vendor is "derived" by the company, the $72 is taxable to the company. This would leave the company out of pocket. Its after-tax position would be:

Loss	($100)
Indemnity receipt	$72
Deficit	($28)
Tax saving (28% of $28 net deduction)	$7.84
After-tax deficit	$20.16

This result generally does not arise if:

- the vendor's liability under the warranties and indemnities is to the purchaser, rather than the company;
- the parties agree that any payments by the vendor to the purchaser under the warranties and indemnities is an adjustment to the purchase price; and
- the company is not a member of a consolidated group with the purchaser at the time the vendor's payment is received.

In respect of second condition above, such agreement is usual in New Zealand. Such an agreement reflects the reality that, had the parties known about the indemnifiable event prior to entering into the agreement, the purchaser would have discounted the purchase price accordingly, and the amount of the discount would have been adjusted to reflect any tax deduction available to the company.

In respect of the first condition (the vendor's liability is to the purchaser, rather than the target company), although it is not conclusive, there is a strong preference to ensure that the indemnities and warranties and payment obligations under them (tax and non-tax) are from the vendor to the purchaser, rather than being from the vendor to the company. If the vendor indemnifies and is required to pay the company, there will be a conflict between the indemnity and the provision stating that any payments under the indemnities are to be treated as an adjustment to the purchase price (which is necessarily a payment between the vendor and the purchaser). If the latter provision does not overrule the former, s CG 4 is likely to treat the receipt by the company as taxable income. Unless the vendor has a

specific gross-up obligation for payments made to the purchaser (which is unusual) the purchaser will be out of pocket.

In respect of the third condition above, even if the purchaser is the indemnified party, where the target company is a member of the same consolidated group as the indemnified party, s FM 9 of the Income Tax Act is likely to treat the payment from the vendor as income.

Section FM 9 provides that an amount is income of a consolidated group where a group company (the purchaser) derives an amount that would be not be income in the absence of that section, but would be income if the consolidated group were one company. Under s FM 9, s CG 4 should be applied to the purchaser and the target company (along with other group companies) as if they were a single notional company. This notional company would be treated as having suffered a deductible loss and been indemnified in respect of that loss. Section CG 4 would apply to treat the indemnity payment as income of this single company and s FM 9 would therefore apply to treat it as income of the purchaser.

If a purchaser is intending to include the company in a consolidated group of which the purchaser is a member, it is likely that it will be out of pocket in respect of any indemnity payment, unless it can obtain a gross-up clause.