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Stay out of the beartraps

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When structuring warranty and indemnity payments, don't let *Zim Properties* catch you out, explains *Alistair Godwin*

What is the issue?

Warranties and indemnities need to be carefully structured so as to avoid any unintended tax consequences.

What does it mean to me?

Where the relevant conditions are met, warranty and indemnity payments can be made to the purchaser free of tax; however, there is always a risk that the conditions are not met so that the concession ESC D33 does not apply.

What can I take away?

The terms of ESC D33 are drafted quite narrowly, and care needs to be taken to ensure warranties and indemnities are structured correctly so as to achieve the desired commercial outcome and avoid a number of significant 'beartraps'.

Warranties and indemnities are a fundamental part of the suite of protections that purchasers require in a private company acquisition. They provide the means by which purchasers can obtain financial coverage for unexpected liabilities (tax or otherwise) of the company that is being acquired. While it may be tempting to think that the warranties and indemnities are just a matter of legal drafting, in fact they do need to be carefully structured so as to avoid any unintended tax consequences. This article discusses some common beartraps seen in practice, as well as possible solutions.

Zim Properties

It is worth understanding the legal origin of this area. The key case is *Zim Properties v Proctor* [1985] STC 90. It concerned a negligence claim brought by the taxpayer against its solicitors in relation to the delayed completion of the

sale of certain investment properties. The negligence claim was settled, with the solicitors agreeing to pay a sum to the taxpayer in instalments. The taxpayer was assessed to corporation tax in relation to this sum.

The High Court upheld this assessment on appeal. Its reasoning was that the taxpayer's right to sue its solicitors was a chose in action that constituted a chargeable gains asset. Receipt of the payment represented a part disposal of that right by the taxpayer, with the sum being treated as a capital sum derived from the right to sue the solicitors as opposed to being derived from the underlying investment properties. It was also held that in computing the chargeable gain arising, the market value of the right at the time of acquisition (i.e. when the claim arose) could (at least in theory) be deducted on the basis that the right was acquired other than by way of a bargain made at arm's length. However, in practice there is unlikely to be any deductible base cost since the taxpayer is unlikely to have given any consideration on acquisition of the right of action itself.

The case had significant ramifications for claimants awarded damages in litigation. It established the general rule that receipts of damages are taxable items. It also had knock-on effects on the taxation of receipts in respect of warranties and indemnities contained in share purchase agreements ('SPAs'), which were presumably not envisaged at the time of the case.

The logic is that warranties and indemnities given to a purchaser confer a right on the purchaser to sue for damages for breach of warranty or, in the case of an indemnity, to recover the amount under the indemnity. Where a payment is made in connection with a warranty or indemnity claim, there would likely be a disposal of the associated right of action on the part of the purchaser, with no deductible base cost likely.

Extra-statutory concession D33

HMRC were alive to the far-ranging impact of *Zim Properties*, and in response they published Extra-statutory concession D33 (ESC D33) in 1988. While there was an HMRC consultation in 2016 on potentially enacting the concession in legislation, to date there has been no movement on the proposals contained in that consultation. Accordingly, ESC D33 must still be referred to. The relevant part is as follows:

> **13. Indemnity payments**
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> The principle in Zim Properties Ltd is not regarded as applicable to payments made by the vendor to the purchaser of an asset under a warranty or indemnity included as one of the terms of a contract of purchase and sale.
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> Where such a contractual payment is made, then the cost of the asset to the person acquiring it will on the occasion of a further disposal be reduced by the sum received. The sale proceeds of the person who makes (or is treated by TCGA 1992 s 171A as making) the disposal of the asset are adjusted under TCGA 1992 s 49 in respect of the sum received. Where a warranty or indemnity payment is not made in accordance with the terms of the contract, the principle in Zim Properties may apply and the sums received by the vendor or purchaser as appropriate may be identified as capital sums derived from the asset, or from the right of action, depending on the facts of the case.

As applied to SPAs, in essence the concession says that – provided certain conditions are met – contractual warranty and indemnity payments take effect by adjusting the consideration payable for the asset under TCGA 1992 s 49, as opposed to being treated as a capital receipt in the purchaser's hands. (Note that this is a tax adjustment only, not an accounting adjustment.)

Where the relevant conditions are met and assuming the purchaser is within the scope of UK tax, warranty and indemnity payments can therefore be made to the purchaser free of tax that would otherwise have arisen under *Zim Properties*. However, there is always a risk that the conditions are not met and so the concession does not apply, and therefore the purchaser would typically insist on being grossed up by the vendor for any tax it suffers on receipt of a

warranty or indemnity payment. This shifts the risk of not falling within the terms of the concession onto the vendor, who would be most concerned to ensure compliance with ESC D33.

The terms of the concession are drafted quite narrowly, and care must be taken to ensure warranties and indemnities are structured correctly so as to fall within its terms. Below are some of the most commonly encountered beartraps, along with possible solutions.

Beartrap 1: The purchaser wants the target to be indemnified

Purchasers occasionally want the warranties and indemnities to be given to the company that is being acquired (the 'target'). This is based on the sensible commercial logic that the target is the entity with the liability that has triggered a claim in the first instance, and so it should be the target that receives the payment. Similarly, if the target had suffered a tax liability of £100 in respect of which the vendor is liable under an indemnity, if the purchaser is indemnified for the £100 it will still be necessary to put the target in cash funds to discharge the liability. Logically, it would simply be easier if the target were indemnified itself so that the indemnity payment could be made to it directly.

Unfortunately, the tax rules do not mirror the commercial logic, as giving warranties and indemnities to the target directly would not fall within the terms of ESC D33, which states expressly that warranties and indemnities must be given to the purchaser only. HMRC guidance at CG 13010 of the Capital Gains Manual confirms that, in general, the payment will be taxable in the target's hands in this case.

One solution is to give the indemnities and warranties to the purchaser but include separate drafting that directs that any payment under them should instead be made to the target. In this construct, the purchaser is beneficially entitled to the payment, but the cash representing the payment is paid to the target. HMRC confirm in the guidance above that this should still be treated as being made to the purchaser, and on that basis it should fall within ESC D33.

This may seem like a simple solution, but there are residual concerns that the cash received by the target may still be a taxable receipt on *Falkirk Ice Rink* [1975] 51 TC 42 principles. It would also create an intercompany debt between the target and the purchaser, which may need managing.

An alternative solution may be to give the warranties and indemnities to the purchaser with the cash payment made to the purchaser, following which the purchaser subscribes for a deferred share (i.e. a share with no voting or other rights and a small nominal value) in the target. This subscription for shares would have the effect of putting cash into the target on a tax-free basis and without creating an intercompany debt. However, the attractiveness of this mechanism must be weighed against the downsides of creating a new class of deferred share which may have other tax impacts, e.g. on the availability of entrepreneurs' relief.

Beartrap 2: US share purchase agreements

Where a share purchase agreement is governed by US law, the likelihood is that US market norms will apply to the scope of indemnity and warranty coverage. On those norms, it is common for indemnities to be given not only to the purchaser but also a wide range of parties, including the target and various other parties related to the purchaser.

To the extent that any of the indemnified parties (other than the purchaser) are within the scope of UK tax, there will be a *Zim Properties* issue. However, it is understood that there is no equivalent in the US, and this can create commercial tensions between US purchasers (who will want the full range of parties indemnified) and UK vendors (who will be alive to the gross-up risks).

To resolve the impasse, the key point is that the indemnity must always be expressed to be given to the purchaser only. But it is possible then to define the amount that the purchaser is indemnified for as being such an amount as would indemnify the target or relevant purchaser-related party. For example, say the purchaser's parent suffered some sort of

loss in connection with the acquisition of the target. The first step is to quantify the amount for which the vendor would have had to have indemnified the purchaser's parent had a notional indemnity been given directly to the parent – say, £100. The vendor would then, in fact, indemnify the purchaser for that £100.

In practice, US purchasers tend to be comfortable with this approach and so it should offer a workable solution – though for completeness note that the indemnity given to the purchaser is likely to be expressed as a covenant to pay instead of a true indemnity, due to technical legal difficulties in indemnifying the purchaser where the purchaser itself has not suffered the loss.

Beartrap 3: Insufficient consideration 'buffer'

A warranty or indemnity payment can take effect under the terms of ESC D33 only if there is a sufficient 'buffer' of consideration that can be adjusted downwards in accordance with the concession. This can be problematic in two practical scenarios.

First, distressed company acquisitions. Where the vendor is divesting itself of an underperforming company, the consideration for the target will typically be low (£1 is common). The low level of consideration means there is no 'buffer' of consideration that can be adjusted downwards in accordance with the concession. It is difficult to think of a practical solution in this case, and vendors normally accept gross-up risk.

Second, so-called hive-down and sale transactions. These are becoming increasingly popular for companies to divest themselves of a trade. Essentially, the transaction involves hiving down the trade to a newly incorporated subsidiary and then selling the subsidiary to the purchaser. The exact details of this structure are beyond the scope of this article, but the objective is to take advantage of the substantial shareholding exemption on any chargeable gains and (since late 2018) intangible fixed asset de-grouping charges that may arise on sale of the subsidiary. Often, the consideration for the trade hive-down is cash left outstanding as an intercompany debt. The objective is to reduce the value of the shares in the subsidiary to a nominal amount on account of that debt, hence justifying low cash consideration for acquisition of the shares by the purchaser. The result should be a low stamp duty charge for the purchaser.

The impact from an ESC D33 perspective is that this means there is little or no cash buffer against which the consideration deduction can take effect. What are the solutions? One is to deem the SPA warranties and indemnities to adjust the consideration for the hive-down as opposed to the share acquisition itself.

From a tax perspective, this could be seen as artificial and open to attack on anti-avoidance principles. This artificiality could be solved by transposing the indemnities and warranties from the SPA to the business transfer agreement governing the terms of the hive-down, but the purchaser is likely to object on the basis that it would still require indemnities and warranties relating to the subsidiary itself in its capacity as a company with separate legal personality, which can only be sensibly placed in the share purchase agreement.

Given the difficulties with these solutions, perhaps the better approach is to capitalise some of the outstanding intercompany debt in order to create a consideration 'buffer'. While this would increase the stamp duty liability of the purchaser, it is likely to be the safest option from a vendor gross-up risk perspective.

Conclusions

If there is one take-away point here, it is that advisers need to be aware that ESC D33 is prescriptively drafted. However, as the above examples show there is often (but not always) a way of achieving the desired commercial outcome while still falling within the rules.

It is also worth bearing the concession in mind as the private M&A market evolves, in particular in relation to W&I insurance. For example, 'synthetic' tax indemnities are becoming increasingly common, whereby a tax indemnity is

included in the purchaser's W&I policy such that the purchaser can claim directly against the insurer. ESC D33 is relevant here as the payer is not the vendor. While there are good arguments that receipts under such a policy are nevertheless not taxable, it illustrates the continuing relevance of ESC D33.
