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Allocating tax risks in private M&A transactions: non-resident capital gains tax

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Introduction

Cross-border private M&A transactions will often involve a seller tax resident in one jurisdiction and a target company tax resident in another. Commonly that target company – the entity whose shares are transferred to the purchaser – may be a holding company, whose principal assets will be subsidiaries that (directly or indirectly) operate the underlying target business in some third jurisdiction (the 'source country').

If, rather than a share sale, the transaction were structured as a sale of the local assets – for example, a sale of the assets of a local branch or permanent establishment – then generally the tax system would allocate taxing rights to the source country. Where, instead, the transaction is structured as a sale of an intermediate, non-resident company – an 'offshore indirect transfer' (OIT) – the source country may still wish to tax the underlying gain (which it may consider remains properly attributable to its taxing jurisdiction), but its ability to do this becomes more difficult and more controversial.

Taxing non-residents on OITs of foreign companies is not new. Many source countries have regimes where the disposal of non-resident companies holding real estate are subject to source country tax: indeed the United Kingdom has recently introduced rules of this kind. So too for companies holding assets derived from a source country's natural resources or from government licences or monopolies: transactions in the extractive industries and the telecoms sector will often have to navigate OIT tax rules (eg, the United Kingdom has long had OIT tax provisions for North Sea oil assets). For deals in these sectors, understanding the OIT position will often be a fundamental part of deal structuring and diligence.

That said, it is an increasingly topical issue more generally. A growing number of jurisdictions are seeking to tax OITs where there is a sufficient level of source country business activity, not limited to the real estate or extractive sectors, including China, India and a number of African and South American jurisdictions. The spectacle of multinationals structuring disposals of significant domestic businesses through offshore holding structures, without paying local tax, has the potential to introduce adverse publicity considerations and political risk on deals in these markets. Prompted by these political sensitivities, in June 2020 the Platform for Collaboration on Tax – a body comprising tax representatives from the International Monetary Fund, the Organisation for Economic Cooperation and Development, the United Nations and the World Bank – published a 'toolkit' for implementing such policies, with a focus on emerging countries. More generally, reports have noted an increasing level of disputes between emerging market tax authorities and multinational groups.

This article focuses on practical considerations for parties that encounter the risk of an OIT charge in a private M&A transaction and need to manage it in the diligence process and transaction documentation. Managing this risk appropriately can be deal critical. The *Vodafone* case in India is a well-known example of what can go wrong: India sought to assess over $2 billion in tax on the disposal, by a non-Indian seller, of a non-Indian target company, to a non-Indian purchaser – and assessed the purchaser for the tax (as a failure to withhold from the purchase price on account of the seller's capital gains tax). The transaction took place in 2006 and the litigation continues today.

Identifying and allocating OIT risk

In a straightforward transaction – for example, the indirect disposal of a single mining asset – the potential for source country tax is unlikely to come as much of a surprise to the transacting parties. However, in a multijurisdictional deal involving target businesses of varying value around the globe, the potential for (multiple) OIT charges is less likely to be top of mind for the principals. Identifying the possibility of OIT charges is first and foremost an important tax diligence workstream.

Generally speaking, where a material risk of an OIT charge has been identified, a purchaser should seek a comprehensive tax indemnity from the seller, including interest and penalties (which in this context can be very material). The key issue here is that although the OIT charge is generally levied, broadly speaking, by reference to the seller's gain, if the (non-resident) seller does not pay, the tax authority will likely enforce against the target's assets after closing (which are within the scope of its taxing jurisdiction). This makes tax risk allocation a critical issue for purchasers. A liability of this kind would not typically be addressed through price adjustment mechanisms in the sale and purchase agreement (eg, closing accounts or anti-leakage covenants).

Addressing OIT risk in transaction documentation

Support for an indemnity provision
The purchaser will, of course, be interested in how this indemnity is to be supported. General warranty and indemnity insurance is unlikely to cover non-resident capital gains charges on OITs in a satisfactory manner. Alternatives to be considered commercially might include an escrow arrangement or deferring a portion of the purchase price; careful thought would be needed as to the appropriate triggers for releasing funds to the seller (or the tax authority).

Rights of conduct and limitations of liability
A seller will likely want robust conduct rights in relation to any tax authority litigation underlying its indemnity obligation, which should be balanced against a purchaser's concern to protect its business and reputation, as well as catering for specific procedural issues (eg, where appeals require advance payment of the disputed tax). Sellers should consider whether time limits and financial caps on its exposure are appropriate, although a principled case could be made by a purchaser that such limitations are not appropriate in this context. If the purchaser is expected to obtain some corresponding tax benefit from the crystallisation of an OIT charge borne by the seller, such as ongoing depreciation allowances, provisions may be needed for the seller to recapture that benefit.

Obligation to withhold tax from the purchase price
Indemnities aside, a purchaser will also wish to know if it is under a legal obligation in the target jurisdiction to withhold part of the purchase price on account of the seller's tax. From the seller's perspective, there is a balance to be struck with having certainty that, at closing, it will receive in full the purchase price set out in the agreement. For this reason, the tax gross-up clause – sometimes regarded as boilerplate – can often emerge as a fiercely negotiated clause in the run-up to signing. A purchaser will want to ensure that gross-up obligations do not apply to its payment of the purchase price, while the seller may want contractual comfort that the purchaser does not in fact intend to withhold at closing.

How this gap is bridged will depend, of course, on the specific facts and circumstances of the transaction, the level of perceived risk around the OIT charge, and market practice in the relevant jurisdiction. The purchaser may, for example, be able to reach a conclusion that it need not withhold based on an appropriate opinion from local counsel. However, there are practical issues to consider here. Who should instruct local counsel and who will get reliance on the advice? If the advice relies on access to the seller's computations, documentation and internal materials, will access to this be forthcoming to the purchaser's advisers? If the purchaser simply obtains sight of the seller's advice on a non-reliance basis, will this suffice for its internal compliance purposes or to mitigate against the risk of penalties? Can it be shared with the purchaser's auditors? Further, any legal advice will, of course, rest on factual assumptions, which should be scrutinised and validated: it may be appropriate to seek to support these by contractual representations (and, indeed, forward-looking covenants) from the seller. In emerging markets especially, the limits of the comfort to be obtained from a legal opinion should also be borne in mind – access to high quality (and non-conflicted) legal advice may be restricted; and ultimately a legal opinion cannot guarantee against the tax authority coming to an aggressive or unorthodox application of the law, or indeed the source country amending its tax law with retroactive effect. Needless to say, the fact that legal advice was sought will also cut little ice from a reputational standpoint if the transaction is presented as aggressive 'tax avoidance'.

Tax clearances and access to books and records
Process points may also impact the agreement and the closing timetable. Is approaching the source country tax authority for clearance on the position necessary or advisable as a closing deliverable (in some jurisdictions this may even be a pre-requisite to a valid transfer of legal title of the target shares)? How reliable is such a clearance in practice? In circumstances where it is agreed that an OIT tax liability will arise, what are the mechanics of the tax – a deemed disposal by the target of its assets, a locally sourced gain of the seller, a withholding by the purchaser or some other mechanism? This may impact drafting in the agreement providing

for which party is to make the relevant filings and by what dates and for review and comment rights where appropriate for the other party. Where the purchaser will be withholding at closing, it will need to engage with the seller in advance to establish any relevant base cost and identify the gain subject to withholding. Post-closing, customary provisions relating to access to books and records and cooperation on tax matters should be reviewed with the OIT charge in mind. Post-closing actions – such as the repatriation of proceeds and the liquidation of entities – should be reviewed in light of any adverse effect that they might have on the OIT analysis.

Comment

OIT tax risk can be an important – sometimes the most important – commercial issue in a cross-border private M&A transaction, with implications for the diligence process, transaction documents and deal timetable. Transactional advisers should look to ensure that the issues are timely identified for signing and that their clients' interests are protected in managing the position after closing. Once risks are identified, a technical OIT analysis should be undertaken for the specific transaction in question – including an analysis of the substantive domestic tax law and treaty, and underlying international law issues around the enforceability of foreign tax laws and the availability of bilateral investment treaty remedies – which would of course inform the parties' approach to the negotiation points above.

While the practice points above focus on contractual issues in the context of a private M&A transaction, remember that OIT issues can also arise in other corporate transactions involving an indirect disposal of an interest – such as an initial public offering, joint venture or co-investment transactions or a public takeover – where there may be less scope in the transaction documentation to negotiate specific provisions.

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