IMPACT OF PILLAR TWO ON TAX RISK APPORTIONMENT FOR A CORPORATE SALE

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How do you draft a tax covenant for a corporate sale when the Seller Group is within the scope of a Pillar Two charge? This is an issue that will become increasingly relevant as we approach the Pillar Two start date at the end of 2023.

Before diving in, there are a couple of observations to make:

→ Tax covenants can have notoriously complex drafting and are at risk of being interpreted literally by a court. In one case from 2012, in their attempt to interpret it, the judge described the tax covenant as a computer programme.

→ However, conceptually the tax covenant is a straightforward price adjustment mechanism. Has the Buyer paid too much for the company? Put another way, is any tax in the target unexpected? This is largely addressed by carving out from cover tax liabilities provided for in the relevant ('price setting') accounts and (if those are not drawn up for Completion) by reference to events occurring outside the ordinary course of business since the relevant accounts date. These concepts help us to understand who should bear the risk of a liability, putting aside the complexity of the drafting to achieve it.

In this article, I look at some types of Pillar Two risk that a Buyer or Seller may be concerned with. Does the typical tax covenant 'computer programme' address the risk currently? Can we draw from points that are relatively settled in the standard tax covenant or is a change in programme needed?

One word of warning, the risks included are not exhaustive and address only multinational and domestic top-up taxes. Given the later implementation date for the undertaxed profits rule, those liabilities are not considered.

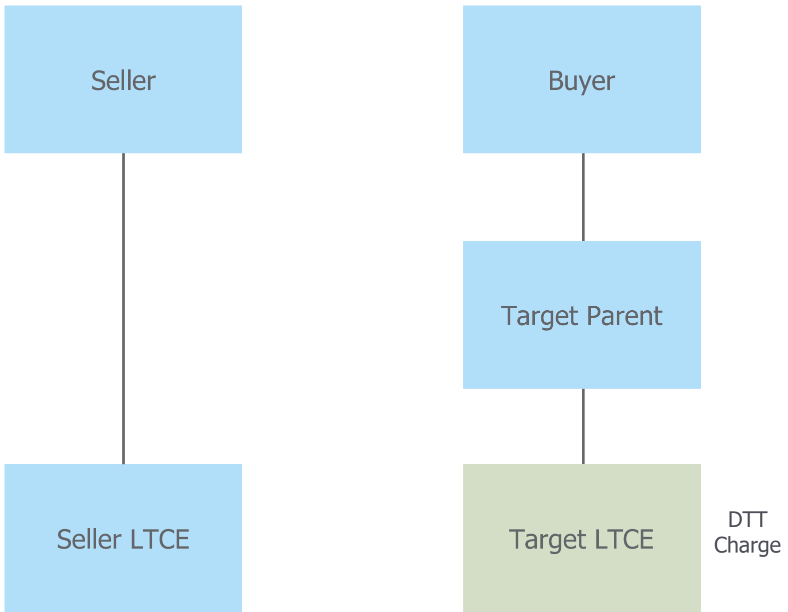
I will generally assume that the target group is moving from one group within the scope of Pillar Two (due to the size of its revenue) to another group within scope. I make a comment at the end about the situation where the Buyer Group is not large enough to be within the scope of Pillar Two.

TOP-UP TAX RISKS

I have divided these into risks that relate to the undertaxation of a low taxed constituent entity ("**LTCE**") in the target group and those relating to the undertaxation of an LTCE in the retained Seller Group. The top-up tax for either could be assessed in the target group or in the retained Seller Group depending upon the facts, such as whether the ultimate parent entity ("**UPE**") in the retained Seller Group is located in a jurisdiction that has implemented Pillar Two.

Let's look at some types of risk.

Undertaxed Target – Target DTT Liability



A target company (the "**Target LTCE**") could be assessed to top-up tax in relation to its own undertaxed profits under the domestic top-up tax ("**DTT**"). This is a good place to start to consider the question whose risk this should be as the tax liability is located in the same entity as the profit. Put another way, should this liability be treated like any other unexpected tax liability? What has happened is that the jurisdiction has adjusted the tax rate that applies to the profit in line with Pillar Two. Is it special in any way?

For a completion date deal a Buyer may want full protection for this risk to the extent there is no provision in the completion accounts. Harder questions come into play when considering an accounts date deal (which, for this purpose, I am including a statutory accounts based deal or locked box deal).

A question for this latter type of deal is whether the DTT liability arises in the ordinary course of business for the period between the relevant accounts date and Completion*. This follows because, although the usual position for an accounts date deal is that broadly the Buyer takes the risk of tax on the profits since the relevant accounts date, there is a typical exclusion for tax arising outside the ordinary course of business.

What is fair? One potential issue is tainting: the risk that the DTT liability in the Target LTCE is higher than it would otherwise have been but for the impact of jurisdictional blending caused by

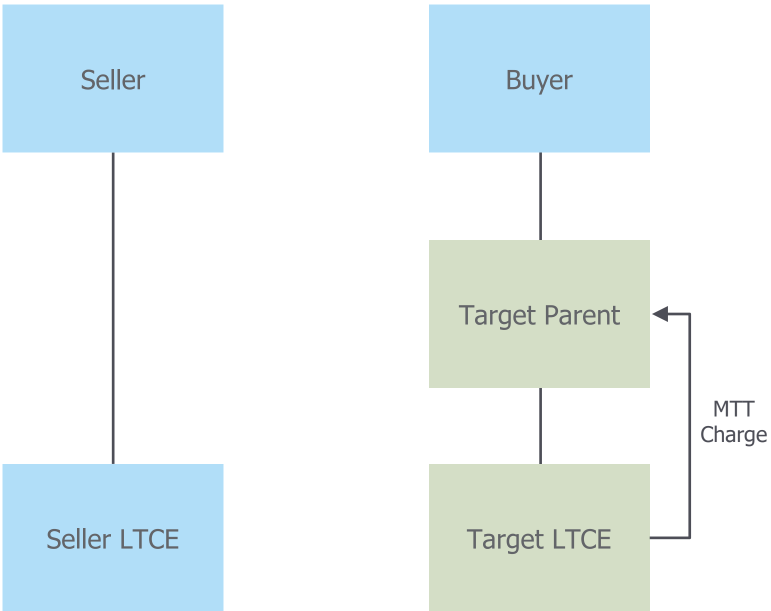
* Completion – Will cover for events/profits before Completion be sufficient? In theory, the OECD rules attempt to form a cut off at Completion. At article 6.2 they say that the constituent entity can be a member of both the Seller and Buyer MNE Groups for the period current at Completion. They then deal with apportionment of top-up tax relating to it (if it is an LTCE) by providing that the top-up tax for the Seller and Buyer MNE Group is calculated by reference to what is in the consolidated accounts for the Seller and Buyer (respectively). However, would the provision work like this to create a clean break at Completion in practice?

an LTCE in the retained Seller Group in the same jurisdiction. Many readers will be familiar with the risk of jurisdictional blending, so I will not rehearse it here other than to say that top-up tax is calculated on an aggregate basis for a jurisdiction.

Does the traditional tax covenant provide an answer for this risk and provide a route for compensation? Does the structure of a typical VAT degrouping clause, which tries to put the parties back into the position they would have been in had the target company been separately registered for VAT (but taking into account the pricing of the deal), provide an answer? These are not straightforward questions.

A further point which is more likely to be relevant when there is a DTT liability is that the Target LTCE may not be wholly owned by the target group and so, if there is provision for compensation between the Buyer and Seller, would this take into account the relevant shareholding percentage?

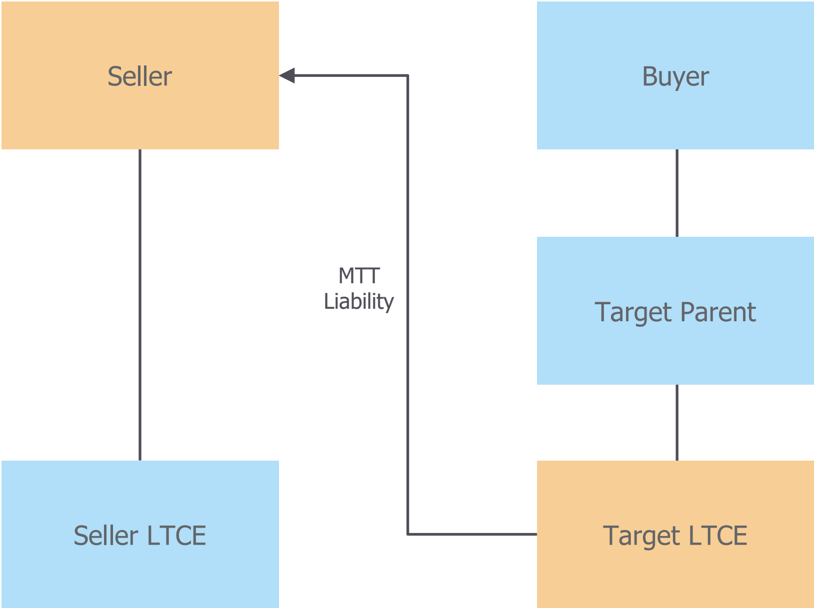
Undertaxed Target – Target MTT Liability



A parent entity in the target group (a "**Target Parent**") may be assessed under the income inclusion rule ("**IIR**") in respect of a Target LTCE's undertaxed profits because the Target LTCE is not in a jurisdiction that imposes a domestic top-up tax and the UPE in the retained Seller Group is not subject to Pillar Two and neither is an intermediate parent entity in the retained Seller Group.

Having considered the position of a DTT liability in the Target LTCE, it is easier to consider this situation. To what extent is a different approach necessary? A difference is that the charge is at a higher level in the target group's corporate chain and takes into account the ownership interest in the Target LTCE. On that basis, arguably a similar approach may work as for the DTT liability in the Target LTCE.

Undertaxed Target – Seller Group MTT Liability



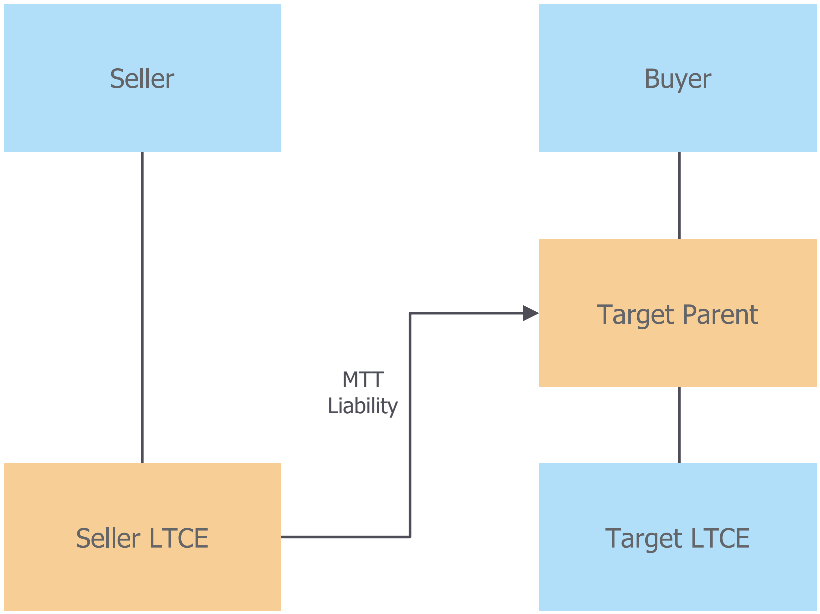
A member of the retained Seller Group could be subject to a MTT charge referable to the undertaxed profits of a Target LTCE because its jurisdiction imposes the IIR and it is a UPE or Intermediate Parent Entity that was higher in the chain of ownership than the Target Parent.

An issue is whether this risk of a charge in the Seller Group justifies protection from the Buyer to the Seller. However, has the Seller received compensation for this liability already through the pricing?

In a completion accounts deal, is it fair to assume that the completion accounts will not provide for the liability on the basis that it is assessable outside the target group? If it has not been provided for in the completion accounts, it will not have affected NAV of the target group, and potentially there is an argument that the Buyer will have paid more for the Target than if the liability had been assessable in the Target itself.

The position is different if the deal is an accounts date deal. In this case, the Buyer may have benefitted from the profits in the Target LTCE from that date, but the member of the retained Seller Group will be subject to a top-up tax in respect of them. How would the Seller want this risk addressed?

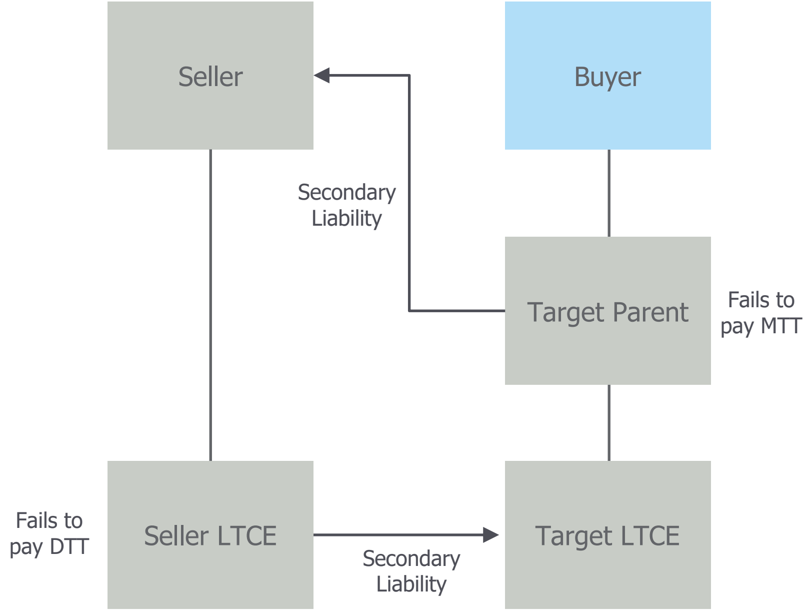
Undertaxed Seller Group – Target MTT Liability



Consider the situation where Target Parent has previously owned an interest in a retained Seller Group company that is a LTCE. In this case, the Target Parent could be subject to a MTT liability relating to the retained Seller Group LTCE (e.g. because the UPE jurisdiction has not implemented Pillar Two). Should the Buyer receive protection for this type of liability where it is not provided for in the relevant accounts?

Furthermore, how would the Buyer know about this risk and know the amount of the assessable top-up tax in the Target Parent given that it is referable to profits of the Seller Group LTCE?

Secondary tax liability for failure to pay MTT or DTT



The UK provisions allow for HMRC to issue a group payment notice and assess a person who is or **was** a member of the relevant MNE group at the time the liability to tax arose. This can affect both the Buyer and Seller side. The diagram above shows possible charges.

Will this risk be swept up in the type of protection for secondary tax liabilities we often see in a tax covenant?

Post Completion adjustment for covered tax

The top-up tax calculation relating to an LTCE owned by the target group or an LTCE owned by the retained Seller Group could be adjusted post Completion and impact on a prior period up to Completion.

For example, this could be because a tax authority raises an enquiry for a prior year. Adjustments could affect MTT or DTT by changing adjusted covered tax: the covered tax balance could be increased or reduced, leading to different results.

If the liability to covered taxes for a prior period is reduced to a significant extent, it is necessary to recompute the effective tax rate and top up amounts for the LTCE in question. This leads to a recalculation of the top-up tax for the prior period (article 4.6.1). If this calculation produces additional top-up tax, the tax is treated as arising in the current year (article 5.4).

As the adjustment could be discovered post Completion in respect of a period prior to Completion, the resultant tax would be treated as arising post Completion, but referable to the period before Completion. It would be an unexpected tax liability not provided for in the relevant accounts.

Should the tax covenant protect the Buyer for this risk? It could relate to understated tax in a Target LTCE or a LTCE in the retained Seller Group. Also, it could be assessed on a member of the Buyer Group that is not within the target group.

If instead, the liability to covered taxes for a prior period is increased, it is necessary to recompute the effective tax rate and top up amounts for the LTCE in question in the current year of discovery (rather than the prior period).

Recapture of deferred tax liability in Target post Completion

There is a risk of a tax liability (a "recapture") arising post Completion relating to a deferred tax liability recognised pre-Completion in a Target LTCE that is not reversed either before Completion or within five years after Completion. The recapture could be in either the target group or the wider Buyer Group through the IIR. This is provided for in article 6.2.1(g).

This is another example of a tax liability arising post Completion. In this case, its incidence arises from a combination of events – those:

→ arising before Completion that gave rise to the deferred tax liability being recognised; and

→ the effluxion of time after Completion.

A typical tax covenant would not have a general combined events clause, so it would not normally be covered by default without express drafting. (Also, the liability could arise in the Buyer Group outside of the target group).

How should this risk be addressed in a tax covenant? Does the typical tax covenant address this type of risk? A liability that has some similarities could be a held over gain reinvested in a depreciating asset (s 154 TCGA 1992) before Completion where the asset is not sold within 10 years. Here again the effluxion of time after Completion (10 years) can lead to the tax charge. Does this help us to think through our approach to the risk of recapture of a deferred tax liability? In any event, a Buyer may want a warranty to establish whether there have been deferred tax liability adjustments to the effective tax rate calculation in the last six years before the sale (alongside a number of warranties the Buyer may want to deal with Pillar Two risk, which this article does not cover).

WHAT IF THE BUYER GROUP IS NOT WITHIN THE SCOPE OF PILLAR TWO?

This may be a common situation: a target group is sold out of a large MNE Group to a smaller Buyer. The Buyer Group's aggregate revenue with the target group may not be sufficient to bring the enlarged group within the scope of Pillar Two because it fails the €750m revenue test. (The OECD rules at article 6.1 set out how the €750m revenue test is to be assessed on a company joining a group.)

Although there is very little guidance, it may be that some (but not all) of the risks above do not apply to a smaller Buyer Group that fails to meet the turnover test with the target group. In particular, this could be the types of risk where the liability arises post Completion: the post Completion adjustment for covered tax and recapture of deferred tax liability in the target group post Completion. The Pillar Two charge is assessed on a period-by-period basis and for each period the turnover test is reassessed.

WHAT ELSE IS RELEVANT FOR THE TAX COVENANT?

This article has almost exclusively focussed on some risks that a Buyer and Seller may want to take into account in the negotiation of a tax covenant where the Seller is in a group within the scope of Pillar Two. However, other factors will be relevant too, such as the need for information rights and potentially a different approach to conduct rights.

The views expressed in this article are those of the author and do not necessarily reflect the views of BCLP.

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