Taxes in Share Purchase Agreements: Pre-Closing Tax Liabilities

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John O'Connor

In the first installment in an occasional series on taxation issues in share purchase agreements, we discuss the provisions in a share purchase agreement that deal with the pre-closing taxes of the target company.

- Every share purchase agreement includes provisions designed to allocate tax risk between buyer and seller.
- While each agreement is unique in its details, certain themes and concepts are common to most Canadian share purchase agreements.
- One such theme is that buyers do not want to be responsible for taxes that relate to the target's pre-closing period.
- It is fairly simple to delineate between pre-closing and post-closing tax periods as there is a deemed year-end for Canadian income tax purposes upon an acquisition of control.
- To achieve the objective of making the seller liable for taxes that relate to a pre-closing tax period, purchase agreements typically make use of two concepts: **net working capital** and a **tax indemnity**.
- In this opening installment of our series, we take a close look at how these two tax concepts function within a typical share purchase agreement.

Net Working Capital

The purchase price for the shares of a target company is typically based on either the target's financial statements as of a specified date prior to closing or an "averaging" of the historical performance of the business (according to an agreed formula) and often with reference to "EBITDA"[1]. Such agreed purchase price is typically cash-free and debt-free and assumes that the business will have a customary amount of "working capital" to permit the business to operate in the ordinary course after closing. The buyer and the seller typically agree upon a "**target working capital**" number in advance of closing which represents the operating liquidity needed in order for the target company to maintain its normal course operations. In order to arrive at such number, in many cases, the parties will apply a base calculation of current assets less current liabilities in order to arrive at the fixed number.

The purchase agreement definition of "**Working Capital**" will be some variant of current assets less current liabilities subject to explicit inclusions and exclusions, some of which may be related to the results of diligence performed on the target company. It is at this stage that it is critical to ensure that the relevant definition is consistent with the previous formulation of the target working capital figure. In terms of taxes:

- **Deferred tax assets and liabilities** tend **not to be included** in (and, in fact, are often explicitly excluded from) "working capital" definitions (as those are accounting concepts which generally reflect timing differences that the parties agree should not be reflected in the purchase price); while
- **General tax liabilities** or "taxes payable" tend to be **included** in such definitions; and
- **Tax refunds** such as those under the "scientific research and experimental development" tax credit program tend to be excluded (although this is deal specific) and, to the extent that they apply to the pre-closing period, there is instead a covenant to pay those refunds over to the seller once they are received (to ensure that the seller receives the amount actually refunded to the target company, rather than the amount claimed, which might be higher).

Assuming that general tax liabilities were originally accounted for in the "target working capital" determination, it is accurate to state that the initial purchase price for the shares was essentially reduced based upon the anticipated unpaid taxes of the target company. If unpaid taxes were not accounted for in the definition of "target working capital", the initial purchase price would not have taken these anticipated liabilities into account and, as a consequence, it may be more appropriate to have taxes excluded from the working capital definition and instead have such taxes result in a dollar-for-dollar reduction of the purchase price (for example, by including such taxes in the definition of "Indebtedness").

The purchase agreement will typically require "working capital" to be determined and prepared as of the closing date of the transaction and be compared to the target working capital figure. The purchase price payable by the buyer to the seller is then typically adjusted (i) upwards if the working capital as of the closing date exceeds the target working capital, or (ii) downwards if the working capital as of the closing date is less than the target working capital.[2]

As noted, general tax liabilities are typically included in the definition of working capital. As such, once working capital is determined as of the closing date, any tax liabilities of the target which will be payable within one year (which should cover any additional taxes attributable to a period prior to closing) should be reflected on the "taxes payable" line item of the working capital calculation. Accordingly, these tax liabilities will effectively reduce the final purchase price payable by the buyer to the seller.[3] It is this rather discrete method by which anticipated pre-closing taxes of a target company are accounted for in many Canadian share purchase agreements.

Tax Indemnity

As noted, all unpaid tax liabilities attributable to a pre-closing period of the target company should be reflected in the working capital. However, in order to provide sufficient protection for a buyer in respect of unexpected tax liabilities that relate to a pre-closing period, most purchase agreements include some form of a tax indemnity which specifically covers this risk. This indemnity is sometimes found in its own section of the purchase agreement although it can also be built in to the general indemnity provisions of the purchase agreement.[4]

A typical tax indemnity will provide that the seller agrees to indemnify the buyer for all taxes of the target company that are attributable to a "pre-closing period" and in respect of the pre-closing portion of a "straddle period" (up to and including the closing date). These two concepts can be defined as follows:

- A **"pre-closing period"** is generally any period which ends on or before the closing date and would generally include all relevant Canadian income tax periods as the target company will be deemed to have a year-end as a result of the share sale.
- A **"straddle period"** is generally a period which includes but does not end on the closing date and, therefore, is designed to capture tax periods which "straddle" the closing date (such that the seller would be responsible for the pre-closing portion only). This concept is particularly relevant for non-income taxes and non-Canadian income taxes of the target company (such as GST or HST).

The obligation of the seller to indemnify the buyer in respect of taxes will generally be net of any taxes that are part of the final working capital calculation (as discussed above). This prevents the double counting that would occur if the seller were required to indemnify the buyer in respect of a tax liability even though the purchase price had already been reduced to reflect that same liability.

There may also be certain **baskets, caps** and **limitation periods** that apply in respect of the tax indemnity claims under the purchase agreement. These are frequently applied in a different manner to the tax indemnity than to the other ordinary course indemnities in the purchase agreement.

- A **basket** is a deductible which provides that the seller will only be required to indemnify the buyer if the amount exceeds a specified threshold. Typically, the basket would not apply to the tax indemnity although this tends to be a matter of negotiation amongst the parties.
- A **cap** limits the maximum amount of which the seller could be liable to indemnify the buyer. It is common for taxes to not be subject to the cap, although this (again) tends to be a matter of negotiation amongst the parties.
- The **survival period** tends to be less heavily negotiated as there is rarely much dispute that tax indemnities should survive for a specified length of time – typically between 60 days and 6 months – following the expiration of the applicable statute limitations period that applies to taxes. With that being said, it is becoming frequently more common for private equity funds – particularly those towards the end of their internal life cycle – to seek to limit this survival period to a shorter period.

Tax Representations and Warranties

It may be surprising to some, but the tax representations and warranties do not play a critical role in indemnifying the buyer for any pre-closing tax liabilities of the target. While a breach of the tax representations may result in an economic loss in respect of a pre-closing period, any indemnification related to this breach is likely, at best, duplicative to that found under the tax indemnity (in most cases, it would be preferable for a buyer to seek indemnification under the tax indemnity rather than breach of the tax representations). With that being said, the tax representations and warranties do fulfil other objectives of the buyer including a diligence function, providing a “walk away” right if there is material inaccuracy in the representations found between signing and closing and, potentially, providing an indemnification right in respect of taxes which arise in a post-closing period. In a future installment of this series, we will discuss the role of tax representations in more detail.

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[1] “EBITDA” means earnings before interest, tax, depreciation and amortization.

[2] Mechanically, this final adjustment will not occur until sometime post-closing – typically between 60 – 90 days – once a full calculation can be performed as of the closing date. It is also not uncommon to see a further interim adjustment whereby an estimate of what the working capital is expected to be on closing date is used to determine the purchase price payable on closing so that the final working capital adjustment (again, typically 60 – 90 days after closing) is smaller.

[3] It should be noted that the Canadian federal income tax returns which relate to the period which ends on the date of closing will not be due until 6 months after the closing date and, therefore, any determination of taxes payable will only be an estimate based upon the *pro forma* determination of this tax liability. Similarly, any tax liability of the target company will not actually be payable to the relevant governmental authority until sometime after closing. It is, in part, for these reasons that some purchase agreements are drafted to exclude taxes from the working capital definition and to include a provision that the seller will pay any such taxes as and when they become due. From a buyer’s perspective, this alternative may not be preferred as it would put the payment of the tax liabilities subject to the seller’s creditworthiness and/or involve more complicated escrow or other arrangements. This approach is not

commonly used in the Canadian marketplace although it is more likely to be seen if there is a non-Canadian buyer.

[4] As a matter of symmetry, if the seller is liable for unexpected tax liabilities in a pre-closing period it should also be entitled to any unexpected tax refunds which relate to the pre-closing period. This is typically reflected in a stand-alone refund provision in the purchase agreement.