TAX

UK High Court considers the meaning of "subject to tax" in a Share Purchase Agreement

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INTRODUCTION

In *AXA SA v Genworth Financial International Holdings, LLC [2020] EWHC 2024*, the UK High Court had to determine the meaning of the term "*subject to taxation in the hands of the receiving party*" in the context of a gross-up clause in a share purchase agreement. AXA, as buyer, had argued that the amounts receivable were "*subject to taxation*" even though they were able to benefit from an exemption in relation to that particular part of the receipt. The argument was that the obligation to gross-up applied if the amounts were merely within the scope of tax and that an exemption from that scope was not material. The High Court disagreed and applied an approach of interpreting the different strands of the contract in a harmonious way to understand the commercial arrangement between the parties.

THE COURT'S VIEW

The basis of the Court's decision was that the commercial intent of the gross-up clause was to ensure that the injured party (in this case AXA) was "*made whole*" against the incidence of taxation on any sums it received. The Court believed that the objective of the clause was that AXA would not be left out of pocket but it would also not profit by way of a windfall. The Court concluded that there was no commercial sense in requiring the sellers (Genworth) to make payments which were alleged to be in respect of tax, yet at that time no tax was payable, it was possible that tax may never be payable and almost certainly would not be payable in the amount that AXA demanded.

There are a number of interesting parts to this decision and some consequences which are discussed below. The key point to remember is that in interpreting contract law (or indeed statute) both the context and purpose are important. Mechanically applying a decision on specific words to a different situation or different context is not a reliable means of interpretation. Whilst it could be argued that, as a result, legal interpretation becomes subjective and therefore unreliable, we would submit that this is the appropriate way to interpret both contracts and statutes.

IMPACT ON DRAFTING

In the case, the parties offered several authorities to the High Court which interpreted the term "*subject to taxation*". It is reassuring that the Court appreciated the bespoke nature of the gross-up clause and focused on the importance of clear language whilst highlighting the inherent dangers of a poorly drafted clause. With this in mind the most immediate impact of this case is on the drafting not just of share purchase documentation but also other market standard documentation such as Loan Market Association facility agreements, ISDAs etc. When negotiating such market standard documentation, consideration should be given to whether an adjustment needs to be made to the standard form given the tax position of the parties. In addition, gross-up clauses can appear in many other commercial contracts such as employment agreements, bonds and other debt documentation as well as general commercial contracts. Consideration on a deal by deal basis should be applied to how each of these are drafted.

IMPACT ON TAX DEEDS

The context of the AXA decision was a desire for AXA to recover losses. This was to be achieved pursuant to a warranty contained in the share purchase agreement. Arguably the concept of "*loss*" inherent in any warranty claim would have resulted in an effective gross-up for AXA for actual tax suffered, but AXA seemed to be arguing for a larger quantum.

The fundamental basis of calculation of compensation under a tax covenant (often referred to as a tax deed) is different. A tax covenant is a simple statement that amounts equal to certain tax amounts must be paid so the concept of loss is not relevant to a tax covenant. As an aside, this is also different from an indemnity which is often based on loss as opposed to specified amounts. Were the Court to interpret a tax covenant (in which the concept of loss is not directly applicable) would it have reached the same conclusion? This is unclear as the

basis for the Court's decision was the fundamental agreement between the parties in that share purchase agreement. In a tax deed, what is the fundamental agreement between the parties? Is it simply to pay specified amounts of tax with a gross-up or is it an indirect means of indemnifying for loss?

IMPACT ON STATUTORY INTERPRETATION

The words "*subject to tax*" appear in many places in the Irish Taxes Act, but clearly the statutory context is different from a contractual term. Accordingly, the same payment might be "*subject to tax*" for the purpose of the Taxes Act but not for the purposes of a contract or vice versa.

In Section 110(4A)(b)(I) of the Taxes Consolidation Act 1997 ("TCA") a deduction is permitted where a payment is "*subject, without any reduction computed by reference to the amount of the interest or other distribution, to a tax which generally applies to profits, income or gains received in that territory, by persons, from sources outside that territory*". The context of this provision was to deny an interest deduction in Ireland where the receipt was an exempt dividend on receipt. If the rationale in AXA was adopted strictly, one might question whether a payment is subject to tax if it is offset by losses of the recipient or if it is taxed in a branch of the recipient where the head office benefited from a branch exemption. In addition, one must factor in EU law which would override such a narrow interpretation and grant a deduction in Ireland for any payment to an EU resident as a result of Section 110(4A)(b)(i) of the TCA.

A different form of words, approximating the same meaning, is found in the definition of "*included*" in Section 835Z(1) of the TCA (the Irish Anti-Hybrid Rules). It states that a payment must be "*chargeable to… tax*" in order to avail of a deduction under the Anti-Hybrid Rules. In interpreting this language, the immediate point is that "*chargeable to tax*" may be different from "*subject to tax*". Also Section 835Z(3) of the TCA requires that the Irish Anti-Hybrid Rules must be interpreted in accordance with the Anti-Tax Avoidance Directive which in turn refers to the OECD Action Items against BEPS. With all of that guidance, it is unlikely that the AXA case would be of much influence on the concept of "*inclusion*" in the Irish Anti-Hybrid Rules.

In Schedule 24, paragraph 9I(4A)(a) of the TCA, dividends flowing through a multi-tier structure are assessed in different ways depending on whether they have or have-not been "*subject to tax*". Paragraph 9I was introduced to ensure that Irish law complied with the decision in ***FII Group Litigation v Revenue and Customs Commissioners [2012] STC 1362*** ("*FII*"). There are deficiencies in this approach that cause regular headaches for practitioners which in turn require that Paragraph 9I be interpreted in a manner that does not strictly follow its language. Clearly an EU decision is binding on the Irish Courts whereas a UK decision is merely of persuasive authority, so in the case of a conflict, an approach consistent with FII would prevail to ensure that freedom of establishment and free movement of capital are protected.

The term "*subject to tax*" also features in provisions relating to the double taxation treaties in the context of distributions to by certain parent companies (Section 831A of the TCA) and determination residence of foreign controlled companies (Section 835M of the TCA). Again these provisions have different statutory objectives and charging provisions such as Section 835M are interpreted against the Revenue whereas relieving provisions such as Section 831A are construed against the taxpayer.

The approach adopted by the Court in the AXA case illustrates the principle of harmonious interpretation. This method of interpretation is used to avoid inconsistency and repugnancy within sections of statute. In Ireland, this principle is often cited in the context of constitutional interpretation. Articles in the constitution should not be construed in insolation but as a whole. Another method of interpretation which applies similar concepts is that of purposive interpretation. This method is specifically captured by Section 5 of the Interpretation Act 2005 which provides that where an interpretation is absurd or ambiguous, the legislation needs to be read as a whole and the intention of the law maker should be applied.

SO WHERE DOES THIS LEAVE US?

The answer is that one must adopt a purposive and sensible (but not slavishly consistent) interpretation approach to both contract and statutes. On the basis that one should only seek to control what is controllable, (and a taxpayer cannot control statutory drafting) proper legal advice from a tax aware lawyer should be sought when drafting a broad range of business contracts (not limited to share purchase agreements and tax deeds) to achieve the correct commercial outcome. Following precedents drafted with a different commercial and statutory context in mind does not always achieve this outcome.

When interpreting statutes, again, a purposive and contextual approach is required and, for example, relevant parts of EU law and OECD commentary may assist. Also, to the extent that a statement of the purpose of the legislation is available, that will assist in the interpretation process. Unfortunately, in the Irish statutory context, a detailed statement of the purpose of tax legislation is difficult to find.

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