CLIFFORD CHANCE

A PRACTICAL GUIDE ON THE MANAGEMENT OF TAX RISKS

THE DRAFTING AND NEGOTIATION OF TAX CLAUSES IN LEGAL DOCUMENTATION

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Dealing with tax uncertainty in an ever-changing tax environment

Over time and as a result of various international tax initiatives, the focus of the internal tax policies of taxpayers (and, therefore, the role of their tax counsel) has shifted from "cost optimisation" to "risk management".

Indeed, the increasing complexity of tax laws, as well as their sensitive (and sometimes inconsistent) interplay, often results in a significant lack of certainty. In this context, detailed tax analysis combined with structuring mitigants may not always provide sufficient comfort, and applications for binding rulings are often incompatible with the timeline of transactions, leaving taxpayers particularly eager to find solutions to manage this uncertainty. In practice, these solutions will generally boil down to mechanics to transfer tax risk, be that via the drafting and negotiation of specific provisions in the legal documentation or by tax insurance.

Conscious of the challenges of negotiating tax risk allocation clauses in an ever-changing tax environment, in particular in a cross-border context, Clifford Chance's lawyers and tax experts have prepared a series of brochures to help taxpayers deal with these matters across different industries, tax issues and jurisdictions.

The first series will cover:

- Financing arrangements
- Investment Funds documentation
- M&A transactions
- Capital Markets structures.

As every taxpayer and tax practitioner is aware, the international tax landscape has changed markedly during the past decade. This is primarily a result of the Base Erosion and Profit Shifting initiative (or BEPS) initially launched in 2013 by the OECD to combat tax avoidance, improve the coherence of international tax rules and foster a more transparent tax environment. This led to the publication of 15 specific reports in 2015, each addressing a particular tax "action".

These reports prompted the adoption of two EU anti-tax avoidance directives (ATAD I and ATAD II) in 2016 and 2017 (respectively), which have since been implemented across all EU member states. These include various tax rules designed to create a minimum level of protection for national corporate tax systems against tax avoidance practices across the EU (including, but not limited to, the notorious anti-hybrid mismatch rules).

In parallel, the OECD adopted the so-called Multilateral Instrument (MLI) to transpose some of the BEPS recommendations and minimum standards in existing double tax treaties, without the need to renegotiate these treaties on a bilateral basis.

In 2024, EU countries transposed the EU directive on ensuring a global minimum level of taxation for multinational enterprise groups and large-scale domestic groups in the Union (the so-called Pillar 2 Directive), while several non-EU countries implemented similar rules in their domestic legislation (based on the Global Anti-Base Erosion rules developed by the OECD, also known as GloBE).

In the meantime, the EU commission has published various EU directive proposals to (i) combat the misuse of shell entities for improper tax purposes (the so-called Unshell proposal), (ii) create a harmonised tax environment that places debt and equity financing on an equal footing across the EU (the DEBRA proposal), (iii) implement a single set of rules to determine the tax base of certain group companies operating in the EU (the BEFIT proposal) and (iv) ensure a common application of the arm's-length principle across the Union (the Transfer Pricing directive proposal).

In addition to these new tax rules, and in order to enhance the ability of tax authorities to tackle aggressive tax planning, several tax reporting regimes have been implemented. This includes the sixth iteration of the EU directive on mandatory automatic exchange of information in the field of taxation (DAC), introducing a new tax reporting obligation for intermediaries in respect of potentially aggressive cross-border tax-planning arrangements (colloquially known as DAC6).

Meanwhile, the provisions of the DAC have been subsequently amended to extend tax reporting obligations to digital platforms (DAC7) and to encompass cryptoassets and e-money (DAC8).

Finally, the EU Commission is expected to publish a new directive proposal to tackle the role of enablers involved in facilitating tax evasion and/or aggressive tax planning in the European Union (also known as Securing the Activity Framework of Enablers, or SAFE).

Although the objectives of these rules are perfectly legitimate and widely endorsed by stakeholders, the fact remains that the relevant provisions have been almost universally drafted too broadly, such that they can both catch seemingly innocent structures and interact in an inconsistent manner with existing rules. In addition, their practical implications have not necessarily been sufficiently clarified during the legislative process (or subsequently by the tax authorities in published guidance).

The combination of sophisticated tax rules, the absence of clarity as to their interpretation (or, for that matter, whether they would be interpreted in a reasonable fashion), the significant amount of tax-related information that is automatically exchanged between tax authorities and the growing appetite of governments to collect additional revenues inevitably leads to significant uncertainty when it comes to the assessment of tax risks.

So what should taxpayers do? In our view, taxpayers should adopt a multistep approach to identify the risk (step 1), assess the extent to which the risk is acceptable (step 2) and allocate the risk accordingly (step 3).

Step 1: Identification and assessment of the tax risk

In practice, tax risks should be identified by the taxpayer's adviser via a bespoke analysis taking the form of a tax note, a tax memorandum or a tax due diligence report. Sometimes, a specific tax opinion may also be required by the taxpayer and/or other parties interested in the transaction (e.g., investors, financing parties and rating agencies) in order to provide additional comfort as to the applicable tax treatment (i.e., confirming that no excessive or unforeseen tax cost would arise by entering into a contemplated transaction).

The main purpose of this initial assessment is obviously not to (artificially) mitigate/decrease any tax due as a result of a specific transaction (which could constitute tax evasion), but to ensure that tax consequences have been properly identified and considered by the different parties involved in the transaction (which would certainly represent a prudent approach, in particular in cases where a taxpayer has a fiduciary duty towards investors). This would involve identifying tax cost and tax risk.

For instance, this assessment may notably be required to determine the expected net rate of return of an investment (i.e., if an investment, once all taxes have been paid, remains profitable), but also to make sure that the taxpayer has sufficient resources to meet its financial obligations and should not become insolvent as a result of an unforeseen tax leakage (in particular in industries with narrow margins).

Once a tax risk has been identified, and on the assumption that no structuring mitigants are sufficiently satisfactory and robust to alleviate its occurrence and that no binding ruling from the competent tax authorities can be obtained because of timing constraints (i.e., prior to the implementation of the transaction), taxpayers will need to enter into a risk management phase.

Step 2: Determination of the acceptability of the tax risk

Given the increased complexity/uncertainty around recent tax rules and their interpretation, the risk that a (genuine) tax filing position is subsequently challenged by the tax authorities is an increasing risk.

Depending on the risk appetite of the taxpayer (which can itself vary based on her/his own risk profile or third-party requests), it could either be acceptable to bear such risk (e.g., because the risk is theoretical or marginal) or err on the side of caution and proactively adopt a prudent filing approach (which would not necessarily be finally endorsed by the tax authorities).

Once a taxpayer has decided to move forward with a transaction notwithstanding the existence of a tax risk (which can to some extent be alleviated via adequate mitigants), the fact that a risk assessment (step 1) has been previously carried out would obviously not prevent such tax from being eventually due/claimed by the tax authorities, but might assist with managing exposure to penalties. A robust and well-delineated tax analysis would also prove particularly useful in case tax insurance is sought by the taxpayer at a later stage (even in a tax audit or tax litigation phase).

In such cases, the taxpayer would be primarily liable, but a secondary tax liability may also arise if the taxpayer fails to meet its own obligations (e.g., in certain circumstances, companies that are part of a tax group can be jointly and severally liable for the tax liabilities of the other members of the tax group and representatives may also be held personally liable for unpaid taxes due by a company).

Step 3: Allocation of the tax risk

Absent any complicity/collusion, the tax risk should only be borne by the taxpayer and/or any person subject to a secondary liability.

This outcome may, however, not be entirely satisfactory and sometimes the actual tax cost would need to be allocated to another person, depending on the economics of the transaction and the rationale of the tax (e.g., because the tax has (solely) been triggered as a result of that other person's involvement or action or in case of withholding taxes deducted at source).

However, unless a tax attribution departing from the primary/secondary liability has been considered properly at an early stage of the structure (and has therefore been contractually agreed between the parties or covered by a specific tax insurance or W&I insurance policy), the taxpayer is unlikely to be compensated for and held harmless against the associated tax cost.

Particular care should therefore be taken on the drafting of provisions designed to allocate tax risks, especially where different jurisdictions are involved and in the case of a different governing law. Indeed, the different parties may not be equipped (or properly advised) on certain unique tax issues that are only relevant in one jurisdiction (or for which the risk of challenge by the tax authorities is more salient). In addition, market practice can differ from one jurisdiction to another, so that what is generally acceptable in one jurisdiction may simply not be palatable in the other, which can in turn result in fraught (often last-minute) discussions between principals and/or opposite tax counsels.

The importance of tax provisions in legal documentation

As evidenced by some authors, while the degree to which clauses in merger agreements are tailored is dependent on timing constraints, the most important clauses can be identified as those for which the level of crafting will remain similarly important when time is of the essence, while more mundane clauses "*are only tailored when there is ample time*".[1] If there is one key takeaway from this series of brochures, it is that taxpayers will always consider tax provisions to fall within the former category instead of the latter.

Although the final allocation of the tax risk is a commercial matter, in addition to the market practice (if any) for such allocation, the parties will need to know the relevant tax rules and understand in which situations they can apply in order to make an informed decision. Therefore, parties should always consult their tax advisers on these questions, as it could result in a significant (unforeseen) tax liability if not considered properly and at an early stage.

The purpose of this series of brochures is to identify the main situations in which a tax cost can be allocated to a person that does not bear any primary/secondary tax liability under statutory law and how this should be addressed contractually, based on the collective experience and extensive track record of Clifford Chance's lawyers and experts.

For ease of use and to allow each reader to focus on the issues that are the most relevant to her/his needs, these brochures are split per practice area.

– Financing arrangements;

– Investment Funds documentation;

– M&A transactions;

– Capital Market structures.

1 The Value of M&A Drafting, by A. Badawi, E. de Fontenay and J. Nyarko

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