WATSON FARLEY & WILLIAMS

CLOSE COMPANIES: BEWARE THE HIDDEN INHERITANCE TAX RISKS OF STRUCTURING ESCROW ARRANGEMENTS AS TRUSTS

28 APRIL 2017 • ARTICLE

It is common practice in acquisitions for the parties to agree to an escrow arrangement to protect the buyer from certain liabilities. These are often structured, sometimes inadvertently, as trusts. This Briefing explains the tax risks for individuals and close companies associated with escrows structured as trusts.

THE NEED FOR ESCROWS

During an acquisition process, unanticipated issues often emerge that could adversely affect the value of the target. These sorts of issues can give rise to significant uncertain liabilities, such as when outstanding litigation is involved. The greater their complexity, the more these issues cause uncertainty between the seller and the buyer as to the quantum of the risk and its financial value.

In an ideal world, a seller will be looking for a clean break and a buyer will be aiming to limit its risk exposure. Typically, they will first look to agree a price adjustment to factor in the risk that has been identified. However, their competing interests in valuing the potential exposure and the likelihood of it crystallising, combined with an ever-looming completion deadline (and plenty of other commercial points that require attention) might cause them to look for another solution. While warranty and indemnity insurance is becoming ever more common, it is rarely available at an acceptable premium for an identified and carefully diligenced risk.

In those circumstances, it is often the case that where the parties are close to signing but the buyer has concerns about the seller’s credit over the potential claim period, the seller might agree to allow part of the purchase price to be placed into an escrow account.

Escrows are typically structured in one of two ways: as a contractual escrow or as a trust. This Briefing considers the key commercial differences and their tax effects.

CONTRACTUAL ESCROW

At its simplest, the escrow will be a designated bank account into which the seller will pay the estimated amount of the liability. The account will often be held by one of the parties' solicitors or a bank (the "account holder") on the terms of an escrow agreement. The escrow agreement will set out the circumstances in which a payment can be made out of the account. Payments will generally be made to the buyer when the buyer has made a successful claim under the terms of the relevant indemnity and the parties will direct the account holder to make such a payment. The balance of the escrow account (if any) will usually be released to the seller automatically at the end of the escrow period. Even after the end of the escrow period, the seller may remain liable under the terms of the indemnity if the relevant liability has not arisen.

This arrangement is probably the most common form of escrow and, subject to agreeing key terms such as how long the escrow should last, it should usually achieve its primary objective. However, a well-advised buyer may look for a different approach if it thinks that the seller could be at a risk of insolvency.

Although the escrow sum is typically held in an independent party's bank account, the seller remains the beneficial owner of the amounts held in a contractual escrow until the buyer has made a successful claim under the indemnity. This means that a liquidator of the seller may include the amounts in the escrow account as the seller's assets.

If the seller is insolvent and the buyer makes an indemnity claim, the buyer will rank against the seller as an unsecured creditor.

ESCROWS AS TRUSTS

A deceptively simple solution to this insolvency risk is to draft the escrow so that the seller is evidently no longer the beneficial owner of the escrow monies – by creating a trust.

Given that such escrows are typically agreed at the end of a deal, it is all too easy to give insufficient consideration to the terms of such trusts, their implications in trust law or their tax effect. The effect of this is that it is sometimes unclear who, if anyone, is the beneficiary of the trust, who is undertaking to act as trustee, and how the contingent beneficial interests in the trust will become interests in possession.

Trust law is a complex area and not every sort of trust is a "fix" to the insolvency risk point.

Some forms of "resulting trust" arise when a person (e.g. the seller) transfers money to another person (e.g. the buyer) to use for a specific purpose (and no other purpose). In that case, the amount held in the escrow account would remain the seller's property until it is drawn down by the buyer and used for the designated purpose.

The buyer has a fiduciary obligation to the seller to use the escrow monies for that purpose and it will breach the trust if it fails to do so. This form of trust is broadly tax neutral but does not protect the buyer if the seller goes insolvent.

The practical solution to protect the buyer from the seller's risk of insolvency is to structure the escrow as a discretionary trust, so that the seller no longer beneficially owns the amount held in escrow.

Until the buyer has made a successful indemnity claim against the seller, it will not have an "interest in possession" in respect of the escrow monies either. The effect of this is that the trust must be drafted as a discretionary trust without an interest in possession.

THE BEAR-TRAP

The downside is that escrows that are characterised as "discretionary trusts" are typically "settlements" within the scope of inheritance tax.

If a settlement is made by one or more individuals or a "close company", an immediate inheritance tax charge can arise. A company is "close" if it is controlled by five or fewer participators, or any number of participators who are directors – but the definition is complex and includes almost all companies that are held by funds. In principle, such a tax charge should not arise in the context of an escrow agreed at arm's length – but the potential for liability should be considered when the agreement is drafted.

Irrespective of whether such an initial tax charge arises, the escrow settlement could give rise to inheritance tax charges when the escrow monies are paid out of the account and on the 10-year anniversary of the settlement (if the escrow lasts that long). Any income (such as interest) or capital gains (which are less usual) will usually be subject to tax at the highest marginal rates of taxation in the hands of the trustees. This potentially reduces the sum of the escrow and creates a risk of non-compliance by the parties.

CONCLUSION

So, in short, where individuals and close companies are involved, trusts are rarely a full solution for escrows as it is difficult to solve the insolvency risk without creating significant tax charges. It is therefore potentially preferable to structure escrows as contractual agreements – but even then, care is required that the drafting does not inadvertently create a trust.

Where appropriate, a buyer should seek a different solution to protect it from the seller's risk of insolvency – perhaps by way of a third party (or bank) guarantee or a registered charge over the account.

KEY CONTACT

FELICITY JONES
CONSULTANT • LONDON

T: +44 20 7863 8944
M: +44 7949 173 830

fjones@wfw.com

DISCLAIMER

WATSON FARLEY & WILLIAMS

Watson Farley & Williams is a sector specialist international law firm with a focus on the energy, infrastructure and transport sectors. With offices in Athens, Bangkok, Dubai, Dusseldorf, Frankfurt, Hamburg, Hanoi, Hong Kong, London, Madrid, Milan, Munich, New York, Paris, Rome, Seoul, Singapore, Sydney and Tokyo our 700+ lawyers work as integrated teams to provide practical, commercially focussed advice to our clients around the world.