SPEAKMAN LAW

Purchase Price Adjustments…

Share sale agreements invariably provide for an agreed price that presupposes a fixed working capital balance at settlement. That balance is often agreed to be zero which will require the purchaser itself to ensure funding of working capital is available immediately after settlement. In other cases it is agreed at the level that has customarily been required to fund working capital requirements. This ensures sufficient working capital to operate the business is already in place at completion.

In either case the purchase price will adjust for variances above or below the agreed working capital target. Where actual working capital exceeds the target, the excess is, subject to tax considerations, added to the purchase price. Where it is below the target, the purchase price is correspondingly reduced.

These concepts are simple. Their practicalities are not. Some examples where the working capital adjustment requires care appear below.

Prepayments: It is not uncommon for a target company to have prepaid expenditure which in part relates to the post completion period. To the extent that the benefit from the expenditure relates to the period after completion, the vendor will want compensation by way of an adjustment to the purchase price. That part is relatively straight forward. Tax issues complicate this however. The purchase price adjustment effectively converts a revenue item (the deduction available to the target company on account of the expenditure) into a capital receipt (and benefit) for the vendor. Willingness on the part of a purchaser to accept this result ought to be predicated on an immediate tax advantage for the deduction. This may in some cases be illusory. That is so where the timing of the deduction falls into the pre-completion period (and is not pro rated under the accrual expenditure apportionment rules). It might also be illusory where the expenditure is directly linked to income that, upon receipt, will be taxable.

Financial Debts: A purchaser will require a reduction to the purchase price for debts owed to the vendor at completion. If no adjustment is made for these amounts, they are effectively a windfall for the vendor. Again, this is relatively straight forward until tax considerations take over. Tax considerations demand a pre-completion dividend in order to take advantage of imputation credits that will otherwise be lost on the sale of the shares. Underpinning the pre-completion dividend is profits in the period leading to completion, and payment of tax in respect of those profits. Problems arise from the fact that the profits will inevitably not have converted into cash at settlement and nor will the precise quantum of profit be known at the time provisional tax is paid on these profits. This inevitably means a debt (the unpaid dividend amount) will exist at settlement. That debt in turn will have been based on an estimated profit position and, by extension, an estimated tax position. This problem is best managed by a pre-completion profit calculation a week or so prior to completion and provisional tax top up at that time. In that way risk on the estimated positions is reduced.

Tax Working Capital: An expectation in all share sales is that tax will have been fully paid or provided for as at completion. That in turn requires agreement on the tax position. It may be that the purchaser takes a different tax view of a pre-completion event that is taken by the target company. In that event the purchaser may seek to tax items to be included in current liabilities (plus penalties), while the vendor opposes this result. While it may be possible to leave such a matter to the tax indemnity provisions, a vendor will not want to complete a sale knowing that a tax dispute sits just around the corner. Nor will the purchaser want to rely on the tax indemnity where a claim is subject to monetary limits. In my experience these matters are best negotiated and dealt with by way of a variation and settlement agreement as at completion.