Tax Implication of Structuring and Financing Mergers and Acquisitions

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Abstract. *The structuring and financing of mergers and acquisitions has substantial tax consequences. The decision to acquire the assets or the shares of the target company should take into consideration, on one hand, the capital gains taxation at the transaction time and, on the other hand, the tax planning opportunities for the future. The tax burden can also be minimized by an optimum selection of the acquisition vehicle. The choice of a financing alternative should take into account the interest deductibility and the specific tax regulations of each jurisdiction concerned.*

Key words: acquisition; merger; taxation strategy; transaction structuring; transaction vehicle.

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JEL Codes: G32, G34, H32.
REL Codes: 11E, 11G.

Introduction

Tax issues have a major impact in carrying out mergers and acquisitions successfully. Analyzing them in the initial stage of a transaction and establishing an adequate tax structure for the transaction can improve the expected results significantly. The purpose of the tax analysis is not only to identify and manage the tax risks, but also to discover and exploit potential tax planning opportunities.

The tax strategy should be established before sending formal offers or letters of intent and before proceeding to a detailed analysis of the target company. The strategy should identify the transaction structuring alternatives and the potential risks and opportunities for tax planning.

The detailed analysis of the target company must include a tax assessment: tax position, tax compliance, prudent or aggressive approach of tax issues, risk areas and tax planning opportunities. Regarding the transaction itself, the analysis should be focused on the structuring of the acquisition price and on the various stipulations in the agreement which might have tax implications.

The transaction structuring in order to exploit the opportunities and facilitate the business integration can add value and maximize synergies. The structuring is made based on the parties' specific objectives and is different from case to case. It can be focused on achieving a creative financing structure, on minimizing the group's tax burden, on the allocation of the acquisition price, on deferring the taxation of the capital gains or on exit strategies.

1. Transaction structuring

1.1. Acquisition of assets or shares

The first important decision on the transaction structure to be made by the company which is considering the acquisition of an existing business is the choice between the acquisition of shares in the target company and the acquisition of assets owned by the target company(1).

From a taxation perspective, the main considerations will generally be the *capital gains tax* consequences to the vendor, and the capital gains tax planning opportunities available to the acquirer (Rohatgi, 2002, p. 461). The purchase of assets rather than shares may also result in a *step up in the tax value* with regard to the assets acquired. The increased cost basis can be used for capital gains tax planning or for depreciation purposes.

It is common to incorporate a *special-purpose company* to execute the acquisition because the sale of shares in the special-purpose company may not give rise to capital gains tax liability. This may, however, be a deferral technique only since an eventual sale of the assets by the special-purpose company may have capital gains tax implications. Any purchase of shares in the special-purpose company may therefore require a discount to allow for this latent tax liability.

In certain jurisdictions, the *goodwill* paid for a business as a going concern may be deducted or amortized. If this is not the case the purchaser may wish to have the purchase and sale agreement worded so that the purchase price is payable for the tangible assets to be acquired, thus reducing or eliminating any element of the purchase price assigned to goodwill. This provides that there are no specific income tax rules as to how the purchase price is to be allocated amongst the various assets purchased. In order to establish the cost bases of all assets acquired in the event of future sales, it is recommended that the sale and purchase agreement record those matters comprehensively, and that all incidental costs associated with the purchase are also recorded.

Example 1: Acquisition of assets or shares in France

In France, the tax treatment of capital gains derived from the disposal of participations has been improved significantly (Etienne, 2006). These gains (excluding those from the sale of participations in real estate companies, participations corresponding to a stake of less than 5% of the share capital or participations held for less than two years) are 95% tax exempt from 2007 in the case of rezident companies. Foreign investors are generally fully sheltered against capital gains tax by the double tax treaties entered into by France. The taxation of individual shareholders is also going to be progressively reduced.

Capital gains from the sale of assets in contrast are fully subjected to tax at the normal rate of 34.4%, while the corresponding benefit of additional step-up depreciations for the purchaser only crystallizes over time. In France, no tax deduction is allowed for the depreciation of most intangible assets (for example, clientele list, goodwill, trade marks). Only patents, because they have a limited useful life, may be depreciated for tax purposes. The step-up in basis therefore only concerns fixed tangible assets.

Therefore, most of the transactions in France take the form of a share deal.

1.2. Selection of the acquisition vehicle

After the choice between the purchase of shares or assets has been made, the second important decision concerns the vehicle to be used to make the acquisition and, as a consequence, the position of the acquired operations in the overall group structure.

The main issues considered in selecting the acquisition vehicle are (White, 2006):

- the choice between a branch or a subsidiary structure for the acquired operations;
- whether there are in the circumstances advantages in interposing intermediary companies (the head office for the branch, or the holding company for the subsidiary).

The choice between a branch and a subsidiary. Forming a branch may not seem to be an option where shares, rather than assets, are acquired, because in this case the foreign entity has, in effect, acquired a subsidiary. However, if the branch structure is desired, but the direct acquisition of assets is not possible, the assets of the newly acquired company may be transferred to the foreign company post-acquisition, effectively creating a branch. Local tax laws usually provide that the assets may be transferred within a company group without crystallizing an immediate capital gains tax liability.

The usual *advantages* of a branch are:

- there are no capital taxes on the introduction of new capital;
- there is no withholding tax on the remittance of taxed branch profits to head office;
- where a foreign branch is likely to incur losses, those may in some countries be able to be offset against the domestic profits of the parent company.

A disadvantage of the branch, against the subsidiary, is that deductions for both royalties and interest paid from branches to the foreign head office, and for foreign exchange gains and losses on transactions between the branch and head office, are usually not allowed, except when it can be identified that the payments are effectively being made to third parties.

Example 2: The choice between a branch and a subsidiary in United Kingdom

In UK (Eyre, Newsome, 2004, Edge, Luder, 2006), branches are subject to UK tax only on their trading income. This means that a branch that carries on only investment activities in the UK may not be subject to tax here at all. This also applies to a branch set up to act as a group finance function. The rate of corporate tax applicable to trading income is 30%. There is no special branch profits tax. Therefore, multinationals pay the same amount of tax whether they trade through a subsidiary or through a branch. There is also no withholding tax on remitting branch profits back to head office. Branches are only subject to tax on capital gains on assets that are held or used for the purposes of the branches' trading activities in the UK. Capital gains are taxed at the 30% rate, though the capital gains regime contains more exemptions and there is an inflation-linked basis adjustment which means that the effective rate of tax can be less.

UK subsidiaries have some special characteristics as well. UK resident corporations pay tax on their worldwide income, including their foreign income. A credit system rather than an exemption system is applicable to foreign dividends. The relevant rate of corporate tax for subsidiaries is again 30%. There is no dividend withholding tax, a factor that levels the playing field between branches and subsidiaries. Tax consolidation is allowed and relatively easy.

It is to be noted that the European Union has adopted directives meant to eliminate any tax on dividends, interest and royalties transferred between affiliated companies in member states (Van den Hurk, 2003, Persoff, 2004). Regarding the distribution of profits, the regulations[(2)] eliminate any withholding tax on dividends and any double taxation of parent companies on the profit of their subsidiaries. Regarding the interest and royalties, the regulations[(3)] eliminate the witholding tax in the case of affiliated companies.

Intermediary companies. Various vehicles may be used to acquire the shares or the assets of the target company:

- the foreign parent company;
- a local branch of the foreign parent company;
- a special-purpose subsidiary in the country of the foreign parent company;
- a double tax treaty country intermediary company;
- a local holding company;
- a partnership;
- other special purpose vehicle.

Special-purpose subsidiary in the country of the foreign parent company. The use of a special-purpose subsidiary in the parent company's foreign country as the head office of the branch, or as the holding company of the foreign subsidiary may have a future tax advantage. The sale by the foreign company of its shares in this special-purpose company may not generate a local capital gains tax liability, whereas the sale of local assets directly will probably generate such a liability.

Double tax treaty country intermediary company. If the foreign country itself imposes tax on capital gains, locating the subsidiary in a third country may be preferred. It is usually preferred a country that has an advantageous double tax treaty concluded with the country of the target company. The third country subsidiary may also sometimes achieve a withholding tax advantage where the foreign country does not have a double tax treaty with the target's country. To be noted, however, that anti-treaty-shopping rules may apply. Also, many treaties stipulate that the company receiving royalties or dividends should be the beneficial owner of these revenues and not just an intermediary in the money circuit.

Local holding company. It is common to interpose a local holding company between a foreign company or a third country subsidiary and the target. The main reason for this is that if the foreign company wishes to acquire another local subsidiary at a later date. This will enable the foreign company to inject funds into the future acquisitions in a higher degree, since it can use the capital of the holding company for the observance of the local thin capitalization rules. Another advantage of the local holding company is that it can be used to receive dividends free of further local tax and reinvest these funds in other group-wide operations.

Partnership. When the acquisition is to be made in conjunction with another party, the question arises as to which is the most appropriate vehicle for this joint venture. In most cases a corporation will be the preferred choice, as it offers the advantages of incorporation and limited liability.

Where the foreign company has or proposes to have other local operations, its shareholding in the joint venture company will usually be held by a separate wholly owned local subsidiary, which can be grouped with the other operations. This grouping may have advantages both in terms of the possibility of transferring tax losses and capital losses between group companies, and compliance with the thin capitalization rules.

Other special purpose vehicles. The use of other special-purpose vehicles such as trust or other partnerships may be appropriate in special circumstances, but specialist advice on the local implications is essential.

Example 3: Societas Europaea

European Union has legiferated the possibility of establishing a European Company (Societas Europaea)(4).

The EU objective was to create a company type with its own legal framework, in order to allow companies registered in the member states to merge, establish holding companies or common subsidiaries, avoiding the legal and practical constraints of the different jurisdictions (Wiese, Lay, 2004).

There are four diffrent ways to create a European Company (SE): through merge, establisment of a holding company, creation of a common subsidiary or transformation of a national joint stock company. The merge is restricted to joint stock companies from different member states.

The establishment of a holding company is permitted only to joint stock companies and limited liability companies with an international activity, having either registered offices in different member states or subsidiaries or branches in countries other than their registration place. The creation of a SE in the form of a common subsidiary is allowed to any public or private entity with the observance of the above mentioned condions.

SE place of registration is established in its by-laws and must coincide with the central administration offices.

In other words, the registered office is statutory and must be real. SE can easily transfer its registered office within EU, without the dissolution of the current company in a member state and set-up of a new company in another member state.

From a tax perspective, SE is treated similar to any other multinational, beeing subjected to the national tax jurisdicions of its registration place and of its subsidiaries. SE continues to taxed in every EU member state where it has permanent establishments.

2. Transaction financing

The main decisions to be made refering to the financing of mergers and aquisions are:

- to what extent to use debt versus equity;
- whether to fund the acquisition internally or externally;
- whether to borrow locally in the foreign acquirer's own country, or whether to borrow in another country.

2.1. Debt versus equity

From a tax perspective, the most important decision is to be made whether to fund the transacition by debt or equity (Klingberg, Lawall, Schmidt, 2004).

Interest payable on debt finance will generally be deductible locally provided that the borrowed funds are used in the income producing activities of the borrower. The major exceptions to this general rule are:

- when the thin capitalization rules are breached, a portion of the interest is not deductible (Rohatgi, 2002, p. 395, Powell et al., 2005);
- interest expenses incurred in respect of acquisitions from related companies may result in debt creation rules being breached, and a deduction being disallowed;
- interest expenses incurred in the production of tax exempt income may be non-deductible.

The deductibility of interest will generally mean that debt is, in principle, a more tax efficient form of finance than equity. When the funds are provided by a related company, debt facilitates the movement of profits from the target's country to the lender's country. If the tax rates in the lender's country are lower than those in the target's country, such a movement in profits will reduce taxes overall. On the other hand, if the tax rates of the target's country are lower than those in the lender's country, equity finance may produce the most favourable overall result.

In the common structure of a local holding company as acquisition vehicle (incurring interest expenses) and a local operating company (earning profits), the flow of dividends to the holding company, and ultimately to the foreign parent, may present a problem. An eventual dividend rebate may be wasted in the holding company, as the dividends may extinguish tax losses.

The solution may be to interpose a further local company between the foreign parent (or lowest immediate foreign holding company) and the local holding company. This new company could have either a dividend access share to the local operating company, or inject preference share capital into the local operating company with a preferential right to dividends. Another solution would be a post-acquisition merger between the holding and the operationg companies, which may allow an offset of the finance cost against the operating profits generated by the target.

Hybrid instruments can be used for the tax planning of the acquisitions (Rohatgi, 2002, p. 562, de Roos and Broers, 2002). Hybrid instruments are for tax purposes either deemed to be shares and treated as equity, or deemed to be debt according to the regulations of the respective jursidiction. The main types of hybrid instruments are the followings: Convertible notes; Preference shares; Perpetual debt; Subordinated debt; Floating rates debentures; Profit participating loans; Index linked debt.

Example 4: Debt financing in the United Kingdom

UK has been among the first countries to introduce restrictions on interest deductibility. The current regulations are sofisticated and require that UK subsidiaries of foreign multinationals prove they are funded in a similar way to as they would be funded if they were independent companies. In order to avoid an agressive aproach of the tax authorities, it is posssible to agee with them in advance on a debt/ equity ratio for the respective company.

Recently, new rules have been introduced to adress hybrid financing. These prevail on the thin capitalization rules and apply when the financing is made using hybrid instruments or entities, with the purpose of avoiding the taxation of interest in another jurisdicion or to deduct the financing expenses both in UK and another jurisdicion (Edge, Luder, 2006).

2.2. Internal versus external financing

The choise between internal financing within the group and external financing from third parties will generally be made on purely commercial terms, based on the overall cash resources of the multinational. The decision to use external funding if borrowed directly by the local entity rather than by the foreign parent will ensure that thin capitalization rules have no application. For this reason, the tax regulations very often contain anti-avoidance provisions which do not allow back-to-back loan arrangements between the foreign parent and an "external lender".

From a taxation perspective, the choice between internal and external financing and of borrowing entities will be governed by the rule that interest should be paid in the highest taxing jurisdiction, and received in the lowest. In the larger context of mergers and acquisitions, however, it will be important to ensure that the chosen borrowing entity has the capacity to absorb the interest deduction, or can transfer it to entities which do have such a capacity.

Example 5: Interest deductibility in France

In France, for example, the thin capitalization rules do not apply to borrowings from third parties like non-affiliated banks, even if the debt is guaranteed by an affiliated company. Therefore, the interest is fully deductible, even if the company has a high debt/equity *ratio. In contrast, the deductibility of intrest on borrowings received from affiliated companies has a double limitation to:*

- *the level of interest on a debt of maximium 1.5 of equity*
- *25% of earnings before interest, tax, depreciation and amortization.*

The interest over these limits is not deductible, but can be carried forward for tax purposes in the next year (Etienne, 2006).

Notes

(1) See "Turkey – Mergers and Acquisitions", PricewaterhouseCoopers, December 2004

(2) See Directive 90/435/EEC, known as the "Parent-Subsidiary Directive"

(3) See Directive 2003/49/EC, known as the "Interest and Royalty Directive"

(4) According to Regulation no. 2157/2001 on the statute for a European company; Directive no. 2001/86/EC supplementing the Statute for a European company with regard to the involvement of employees.

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