After the acquisition: tax planning for business integration

Integration of newly acquired foreign businesses poses as many tax challenges as the acquisition itself, cautions William Chip

Much has been written about how a multinational enterprise may secure domestic and foreign tax benefits when acquiring a foreign target. Less has been written about the tax-efficient integration of subsidiaries that the buyer and target happen to own in the same countries.

Business purpose opportunities

For the buyer, a cross-border acquisition presents mostly tax opportunities, such as maximizing the tax deduction for acquisition indebtedness or amortizing acquired intangibles. The tax pitfalls, such as taxation of gain on the sale, are mainly the seller’s problems, and the seller can be expected to look out for itself. However, once the target is acquired, and the focus shifts to integrating a subsidiary of the target with a legacy subsidiary in the same jurisdiction, one of the subsidiaries will assume the role of local buyer and the other that of local target, forcing the common owner to assume the tax risks of both sides of the integrating transaction.

While the tax pitfalls of integrating legacy subsidiaries are real enough, the opportunities are nonpareil. In fact, the post-acquisition integration of two global enterprises may afford the tax director the most significant opportunity of his career to introduce sophisticated tax-reduction technology into the corporate structure. Management’s imperative to unify the pre-existing and acquired businesses will often establish a business purpose for strategies that use partnerships, tax-free reorganizations, and other mechanisms that would be less supportable if implemented solely for tax purposes.

Typically, management will wish to integrate the pre-existing and acquired businesses as quickly as possible, putting the tax director under considerable pressure to identify simultaneously tax-reduction opportunities and tax pitfalls in many countries. Because multinational enterprises already operate their global business units with little regard to legal entities (to the distress of their lawyers and accountants), there is always the risk that business integration decisions will be made before the tax analysis is concluded.

Integration’s Holy Trinity

The tax opportunities that arise when a buyer must integrate newly acquired and pre-existing business operations in the same jurisdictions fall within three broad categories:

- local tax consolidation of the financial results of the pre-existing and acquired businesses (while avoiding the extinguishment of pre-consolidation tax attributes);
- increasing the indebtedness of the combined companies in various ways (with the attendant risks of transfer and capital gains taxes); and
- structuring tax-free cash repatriations and other beneficial transactions.

Tax consolidation

It almost always increases tax efficiency to enable losses of the newly acquired business to be offset against profits of the pre-existing business and vice-versa. This offset can be achieved by merging the two business entities, where that is legal and practical, and otherwise by tax consolidation. Most countries permit some form of tax consolidation or “fiscal unity” whereby the tax losses of one group member may be offset against the taxable profits of another group member (or “surrendered to” a profitable member). With few exceptions (notably the UK and Australia), turning the acquired or pre-existing company or a newly formed holding company into a common local parent will be necessary.

The goals of tax consolidation are everywhere the same:

- to permit the offset of future losses against future gains;
- to preserve pre-consolidation tax attributes of the target and survivor and
- to avoid transfer tax and capital gains tax on the consolidating transaction.

It is precisely in these areas that local rules tend to diverge from international norms, and tax directors will trip themselves up if they act without counsel from the best local advisers.

On the whole, mergers, while offering the purest form of prospective tax consolidation, pose the greatest risk of impairing historic tax attributes. Here, the tax director with a mainly legal tax background does well to make friends with a good accountant in each integrating jurisdiction. In most countries, the tax results of an integrating transaction will follow the accounting results, and nowhere is local Generally Accepted Accounting Principles (GAAP) more likely to diverge from US GAAP or International Accounting Standards than in the area of combination or purchase accounting.

Mergers are often favoured by management because they simplify the organization chart and usually reduce the number of tax returns and other statutory reports that the business must pay to be completed. However, mergers are much more easily accomplished when the merging companies are commonly owned, so the first order of business may be extracting one of the companies to be merged from its current owner, at the peril of capital gains and transfer taxes. Very useful in the US context is section 355 of the Internal Revenue Code (IRC), which confers tax-free status on corporate divisions that meet a variety of tests, including a five-year business history for the distributed and undistributed businesses.
Some countries still do not permit tax consolidation. Even where consolidation is permitted, the corporate actions required to achieve tax consolidation may face insurmountable business, legal or tax obstacles. In such cases, corporate structures that achieve the near equivalence of consolidation may be available. In Italy, where until this year tax consolidation was unavailable, a holding company with losses could sell back to its profitable subsidiaries the imputation credits on dividends paid by those subsidiaries, a strategy that effectively allowed a parent to surrender net operating losses to its subsidiaries. This possibility itself gave rise to “debt pushdown” strategies whereby a newly formed Italian holding company would incur a tax-efficient loan to purchase a pre-existing Italian operating company.

A near equivalent to consolidation may sometimes be achieved by forming a partnership between the pre-existing and acquired companies, whereby the post-integration tax attributes (whether profits or losses) of the combined businesses become available to both companies without impairing pre-integration tax attributes. Less obvious, but intriguing, is the use of swaps and other risk-transfer agreements to shift profit and loss between related contracting parties.

In the US, it may be possible to form a partnership for tax purposes without creating a new entity or moving any assets. An appropriately drafted agreement may by itself establish a partnership for tax purposes, provided that business profits and losses are shared, neither party may sell business assets without others’ consent, each party indemnifies the other for business-associat ed liabilities, each party agrees to “true up” for disproportionate losses, businesses are to be carried on under a single trade name, new assets are acquired in the name of the joint venture and the businesses are accounted for as a joint venture.

The US entity classification regulations, which permit a relatively easy conversion of taxable companies into entities disregarded from their owners, can be used by foreign owners of multiple US subsidiaries to generate a de facto consolidation. “Checking the box” to elect disregarded status will convert them into divisions of a single branch that files a single, common return. However, the conversion is a liquidation, which can result in taxation of built-in gain unless certain requirements are satisfied, such as retaining the assets in a US trade or business for 10 years.

**Debt pushdown**

There are three basic strategies for integrating a pre-existing and newly acquired subsidiary in the same country:

1. They may merge;
2. One subsidiary may be contributed or sold to the other; or
3. Both subsidiaries may be contributed or sold to a newly formed holding company.

The currency for the acquisition may be cash or shares, either shares of the acquiring company or shares of its parent (although some countries, such as France, prohibit a subsidiary from owning shares of its parent). Whether cash or shares are used, the acquisition of one company by another is often an opportunity to introduce (push down) additional debt into the integrated group. Even if shares are used, a participant in the transaction may borrow money to acquire the shares.

The funds for an integrating acquisition may come from external lenders and fulfill a funding need of the integrated companies. Alternatively, a debt instrument may in effect replace pre-existing equity with no infusion of new funds into the group. Such synthetic debt affords an important opportunity for tax arbitrage, either because the creditor is in a higher tax country than the debtor, because the creditor has net operating losses, or because the debt is a hybrid instrument that is equity for the creditor and debt for the debtor.

Debt pushdowns using hybrid instruments and entities may be less controversial than other tax-reduction strategies because they are premised on a difference of opinion among tax authorities rather than a difference of interpretation between the taxpayer and any tax authority. Consider, for example, the following excerpt from a March 18 2003 speech by the chief counsel of the US Internal Revenue Service (IRS):

We are confident in the principles and integrity of our tax law and, unless the law requires otherwise, we will determine the appropriate tax treatment of an item based...
solely on the application of US law…Except to the extent foreign commercial law is relevant in applying those tests to determine rights and obligations,…the determination will be made without regard to the foreign tax treatment.

However, in the same speech the chief counsel warned that hybrid entities and instruments that purport to achieve duplicate deductions will be closely scrutinized, and that taxpayers that attempt to exploit them must take great care to follow the form they believe will govern the local tax treatment.

A similar attitude reigns within the EU. For example, it is well known that most European tax authorities analyze repo transactions differently from their US counterpart, creating important opportunities for double deductions of interest. While not departing from their customary positions on how to classify such transactions, the French and perhaps other EU tax authorities are increasingly vigilant with respect to the execution of these strategies and may challenge carelessly structured deals.

The opportunity to introduce synthetic debt when integrating local companies may be constrained by local thin capitalization rules. Most countries limit the amount of related party debt, compared to their equity, on which a company may deduct interest. Several that did not have such limits (Italy and the Netherlands) have recently introduced them, and several that already had them have recently tightened the rules (Denmark, Germany) or have threatened to do so (US).

There are many variations on how to measure thin capitalization. In some countries, the permitted ratio of debt to equity is based on the fair market value of the equity, on others on the book value. In some countries, only debt from affiliates (or guaranteed by affiliates) is counted against the limit, in others all debt is counted. Some countries exclude inventory financing from the limit, others do not. Some countries, such as the US and UK, look at “cover” (that is, the ratio of interest expense to income) as well as the debt-to-equity ratio.

Overcoming thin capitalization limits is often the principal challenge to debt-pushdown planning, and many strategies for doing so have been developed. While the maximum debt pushdown would be achieved by having the less valuable company buy the more valuable company, thin capitalization limits may make the opposite transaction more beneficial if the more valuable company has more “thin cap capacity” because of greater equity or relatively less debt. Thin capitalization limits can in some countries (such as Spain) be magnified by tiering of companies (that is, equity double leverage).

**Structural opportunities**

The most powerful international tax strategies often depend on partnerships, tax-free reorganizations and other structuring approaches where the absence of a business purpose for the structure may affect the tax outcome. A bona fide business purpose for combining previously distinct business organizations affords an excellent opportunity to implement these strategies.

There are many examples under US tax law, both for inbound and outbound integrations. For example, IRC section 304 treats the purchase of one subsidiary by another as a distribution of earnings from one or both subsidiaries, resulting in dividend income to a US shareholder of non-US subsidiaries or withholding tax for a non-US shareholder of US subsidiaries. (There is an exception for companies purchasing subsidiaries they already indirectly own.) The dividend income and withholding tax, respectively, may be avoided if the purchase is structured to qualify as a tax-free reorganization by liquidating the target (actually or constructively by “checking the box”) and including some stock of the buyer in the purchase consideration. Unfortunately, the IRS is thinking of curtailing such transactions.

Combining companies in the right order and the right way may also result in a combination or blending of basis that facilitates the movement of cash or companies within a corporate group by reducing gain that might otherwise result from the distribution of shares or of cash. For this reason, the acquisition of a foreign company may facilitate the unwind of the “sandwich” structures that are so problematic under US tax rules.

**Slings and arrows**

While post-acquisition integrations impose unusually stringent deadlines and a confusion of rules as the same objectives are sought in jurisdictions with markedly different regimes, the basic tax tools come from the tax director’s standard kit. Nevertheless, post-acquisition integration planning throws up a number of questions and obstacles that may be unfamiliar to even a sophisticated tax professional. While none of them are insurmountable, they can decelerate the integration process if they are not anticipated. As far as management is concerned, slowing down the business integration may be just as bad as not getting any tax benefits.

While no amount of tax complexity could shock a US tax director, the non-tax problems that must be confronted are a different story. The US may have the world’s most complicated income tax system, but US income tax planning can to a significant extent be undertaken without concern about potential legal and transfer tax obstacles. Mergers and other business-combination transactions can be undertaken quickly...
and inexpensively, and the impact of real estate and other types of taxes is ordinarily immaterial or manageable. Not so outside of the US, where capital duties, share transfer taxes, VAT, real estate transfer tax, and other impositions present very large costs even compared to the potential income tax benefits. While a number of countries (for example, the Netherlands) exempt most corporate capital gains from income tax, a number of important tax jurisdictions (for example, France) still do not. In some tax jurisdictions capital gain may be avoided by distributing sufficient earnings to reduce the company’s value to its tax basis, lending the money back if needed by the company.

Important corporate transactions within Europe must typically be reviewed by an EU-mandated works council and sometimes also by a locally mandated works council. While the councils ordinarily do not have veto power, they can delay corporate transactions through procedural manoeuvres or court proceedings. Every adviser on a major EU acquisition has an inventory of works council “war stories.”

The works councils will ensure that the proletariat is not forgotten, but the capitalists are easily overlooked. The tax professional advising on a business integration must never fail to ask whether there are minority shareholders in either company. If the minority interest is not economically significant, the information may not be volunteered, but even the tiniest minority may have notice, valuation or buy-out rights that can impede the progress of integration. No one may remember who owns that 0.1% interest, and important integration steps may be delayed for a year while the search for the missing owner is undertaken.

The battle within

Business integration brings into play not only the tax function, but also management of the affected business unit, the law department, and the corporate treasury, each of which may exercise a veto over tax planning. Treasury may be the least flexible function because of its huge intellectual investment in the sophisticated and sometimes fragile cross-border cash management structures that preceded the integration process. Moreover, unlike operations management and the law department, treasury executives may not assert their interests until asked to do so. Early involvement of treasury in the planning process, as well as an understanding of “the treasury view,” are therefore essential steps for the tax director devising a successful integration plan. Working with treasury executives on a “tax map” that lays out the principal funding flows, showing the origin of loans from equity capital or external debt, may be a useful exercise. Also useful are spreadsheets that track inter-company debt with the ability to consider changes in principal, interest rates and tax effect.

Tax input crucial

Major foreign acquisitions are life-altering events for multinational enterprises. They stir the enthusiasm and engage the energies of the company’s senior leaders and functionaries. Typically, the valuation put on the target by the investment bankers is only marginally greater than what the buyer is willing to pay, with the consequence that demonstrating the potential for post-integration tax savings may be critical to closing the deal. The tax director is a valued member of the acquisition team, and everyone basks together in the glow of the “done deal.” However, once the deal is done, the “blocking and tackling” of integrating business operations in multiple jurisdictions must commence in short order. Top management will be engaged in the battle over who gets to run which business in which country. The tax director is mostly “on his own!”

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