Tax Implications of Merger and Acquisition Transactions:

GENERAL TAX TREATMENT OF M&A TRANSACTIONS IN RUSSIA TAX RISKS STEMMING FROM M&A TRANSACTIONS RISKS OF ADDITIONAL TAX LIABILITIES WITH RESPECT TO ACQUIRED COMPANIES, HOW TO BEST IDENTIFY THE AMOUNT OF ACQUIRED COMPANIES' LIABILITIES TOWARDS THE BUDGET WAYS TO DEAL WITH TAX RISKS AND DEVELOPMENT OF AN OPTIMAL TAX MODEL FOR M&A TRANSACTIONS

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From the legal point of view the mergers and acquisitions process may be completed in the following format:

1) reorganization;

2) liquidation of a company and transfer of its assets to the entity that has taken the aforesaid company over;

3) incorporation of the company into a group of holding companies.

In the first instance, assets and liabilities of two different entities comprise one company (one legal entity). In the second instance, only participants (shareholders, owners) of the company included in the holding will vary.

We are going to review tax consequences of various forms of mergers and acquisitions.

Mergers and acquisitions in the course of reorganization

Reorganization of operating legal entities resulting in the unification of their assets and liabilities within the framework of one company may be performed in the form of merging one legal entity with the other or in the form of amalgamation of two earlier operating companies to form a new one.

In the first instance, the overtaken company is liquidated and its assets, property, rights and liabilities pass over to its legal successor. The aforesaid successor, i.e. the company that takes over the former company is not liquidated, but rather continues its operations, however, not only on the basis of its own assets, but utilizing assets of the overtaken company, besides, the successor has to settle not only its own liabilities, but also liabilities of the overtaken company.

When companies are consolidated, two entities participating in the transaction are liquidated in order to ensure that their rights and obligations are transferred to a newly founded legal entity.

Legal aspects of reorganization

Tax liability

Liabilities are transferred in the course of mergers and acquisitions under a delivery/acceptance report. Such delivery/acceptance report shall among other things specify the amount of outstanding liabilities associated with unpaid taxes and levies.

The successor shall execute liabilities of reorganized companies associated with outstanding taxes and levies. In such instance, the aforesaid successor shall settle:

- all liabilities revealed prior to the completion of the reorganization process and set out in the delivery/acceptance report, including liabilities associated with taxes, levies, penalties and fines for any tax legislation violations;
- liabilities associated with taxes and levies revealed by tax authorities after the reorganization process was completed as well as penalties for their untimely payment.

In such instance, tax authorities may not demand that the successor pay fines levied thereupon after the completion of the reorganization process in connection with violations occurred through the fault of its predecessor prior to the completion of the aforesaid reorganization process.

Thus, if companies merge or any company is acquired, one should not be afraid that any liabilities may arise in connection with the execution of sanctions for tax violations that occurred prior to the reorganization. However, sanctions usually constitute an insignificant portion of tax liabilities (10-20%, in rare cases 40% of the outstanding tax amount). A greater amount is charged by tax authorities in connection with liabilities related to the payment of taxes and penalties. As it was said above, such liabilities are subject to execution by a taxpayer regardless of the time when the fact of tax underpayment is established: prior to the completion of reorganization or upon its completion.

Thus, a reasonable approach towards the acquisition of a company by way of its takeover or merger implies the stock-taking of the company's tax liabilities. In such instance, it is important that the accuracy of the computation of taxes payable by the overtaken company be controlled over the period that may be audited by tax authorities. Such period comprises three preceding calendar years and this current year.

Out of such period it would make sense to do the stock-taking of periods that were not audited by tax authorities; however, Russian legislation provides for a possibility to do a repeated audit of already audited tax periods in the event of a company's reorganization. For this reason, in order to eliminate the risk that new tax liabilities may arise, it is important to examine periods that were already audited by tax authorities as well.

Latent tax potential

The examination of the tax liabilities accurate computation by the overtaken company may have a different meaning, in particular, determination of such tax liabilities that have been calculated by the company in excess of tax rates.

Here one may find obvious errors and excessive payments occurred due to the indefinite nature of tax legislation that made the company decide not to run any additional risk and apply the law the way it is interpreted in order to avoid any claims of tax authorities.

For the purposes of the determination of the audit period one should not be constrained by a three-year period as tax legislation provides for a possibility to get a refund of taxes from the budget after expiration of a three-year term from the date of excessive payment of taxes. However current legislation does not prohibit offsets of tax overpayments against repayment of arrears related to other taxes and against deferred tax payments due at any other time after the aforesaid period expires.

Example

A company appraised the feasibility of a transaction related to the takeover of another company that had a billion tax arrear payable to the budget. The acquiring company conducts a legal audit of (accuracy) the calculation of the number and value of assets and liabilities of the acquired company. Legal advisers engaged to complete the assignment disclosed that tax liabilities were in some instances overstated and in other instances understated. However, correctly estimated balances of settlements with the budget as at the time of the company's reorganization mean that it is not the company that owes taxes to the budget, but the budget should refund excessively calculated and paid tax amounts.

The company agreed to accept the offer to acquire the company and did not argue against the stated book value of its tax liabilities, and upon completion of the reorganization process filed adjusted tax declarations to tax authorities, having provided detailed specification of tax liabilities for previous periods, filed an application for the refund of excessively paid tax amounts that were in part voluntarily satisfied by tax authorities and the rest was recovered through court.

Tax problems and their resolution with respect to each particular tax

Profits tax

Under paragraph 3 Art. 277 of the RF Tax Code "when a company is undergoing a reorganization process regardless of the form of said reorganization, no profits (losses) recognizable for taxation purposes are accrued in accounts of taxpayers – shareholders …".

This rule allows:

- not to include in the income the positive net asset value of the acquired or merged company;
- not to include in expenses the negative net asset value of the acquired or merged company;
- not to include in the income of a successor (newly established company) the difference be-

tween the market value of assets of the acquired (merged) company and the paid-up value of its stocks, and if such difference is negative – not to include it in expenses.

Value Added Tax

VAT Accrual

In accordance with subparagraph 2 paragraph 3 Art. 39 of the RF Tax Code the transfer of the company's assets to its successor(s) is not deemed to be a sale of such assets in the course of the reorganization of such assets. The application of such rule is not contingent upon any actual circumstances related to the reorganization, including in connection with the structure of assets of reorganized companies and the value of such assets. Thus, the transfer of such assets to a successor in the course of the company's reorganization does not result in an obligation to pay VAT.

VAT deduction and restoration of VAT amounts that were earlier made deductible

A successor of a legal entity that was reorganized in the form of a takeover shall have the right to VAT deductions that was formerly owned by a reorganized taxpayer.

Such right arises for a taxpayer over such tax period in which it was established.

However, we were unable to find any legal precedents directly confirming or denying our conclusions made above with regard to potential deductions made by the successor. Thus, it is uneasy to predict a decision of the court regarding a potential dispute with tax authorities. However, we believe that if the company engages professional advisers it will be possible to sustain the right of the company-successor to VAT deductions in court. But if by the time of filing a case to court any negative precedent arises, it will not be easy to change it.

One may avoid VAT restoration and disputed associated with further deductions application in the following manner. Assets at the time of the purchase whereof a VAT was paid shall be sold prior to the company's liquidation to the acquiring company at the market value or at the price deviating for not more than 20% form the market price and at the time of the company's reorganization only cash generated from the aforesaid sale should be transferred to the new company. In such instance VAT may not be restored, and if VAT was not made deductible in the past in connection with such assets, the company is not going to lose a right to such deduction. The buyer (and the successor at the same time) may make VAT deductible that it paid to the acquired company.

In the event of a merger such variant of the elimination of tax risks is not applicable as it is not possible to sell assets to the company's successor (it will be set up at the same time with the liquidation of merged companies).

Unified social tax and compulsory pension contributions

Chapter 24 of the RF Tax Code is devoted to the payment of the Unified Social Tax (UST), provides for the application of so called "regressive scale" convenient for a taxpayer because it helps save a lot of funds. The regressive scale of taxation means that the greater amounts payable to the company's staff the lower is the UST rate for companies. The UST rate is selected individually per each employee, but the compliance with conditions making the company entitled to apply the aforesaid regressive scale is checked for the whole company.

The general scheme of the UST payment is as follows. Advance UST payments are made on a monthly basis. In order to determine which rate shall be applied for the purposes of said advance payments calculation the tax base accrued starting from the beginning of the year per each employee is estimated and then divided by the number of months expired over the current year. If it amounts to less than 2500 RUR, the company may not apply the regressive scale and shall pay the tax at the maximum rate thereof. In such instance, taxpayers may not apply the regressive tax rate scale until the tax period end.

The following questions arise in connection with mergers and acquisitions with regard to the calculation o the average tax base:

1) if at least one company that participated in the merger (acquisition) failed to meet requirements for the purposes of the regressive scale application, does it mean that after completion of the reorganization the successor will not be able to apply the regressive scale until the year end.

Example 1

Company À merged with company B in February of 2004. In such instance the average tax base for advance payments in January exceeded the threshold of 2500 RUR in the case of company A, and failed to exceed the aforesaid threshold for company B.

For the purposes of the calculation of the advance payment in February the tax base exceeds 2500 RUR in general. Can the successor apply the regressive scale? The question arises because company A is a successor of company B that was unable to apply the regressive scale;

2) whether payments made prior to the reorganization and the number of months prior to the reorganization are taken into account for the purposes of the determination of the regressive scale or not.

Example 2

Company À merged with company B in May of 2004. The uncertainty of current legislation causes disputes regarding how the base shall be calculated in such instance. There are advocates of the following variants:

- When the advance payment is calculated for February the tax base generally exceeds the amount of 2500RUR. Can the successor apply the regressive scale or not? The question arises as company A is a successor of company B that was unable to apply the regressive scale;
- At the time of the merger for the purposes of the calculation of the advance payment for May in order to calculate the average tax base one shall take the base accrued from the time of the reorganization completion (the base for May only) and it shall be divided by the number of months upon the completion of the reorganization process (one). Advocates of such variant believe that such variant is adequate because the tax period at the time of companies' reorganization commences from the time of completion thereof, i.e. for a reorganized company the tax period is deemed to be the period from May through December;
- When an advance payment is calculated for May for the purposes of the average tax base calculation one shall take the base accrued starting from the beginning of the year (January-May) for all reorganized companies and divided by the number of months starting from the beginning of the year (five months). Advocates of such variant believe it to be adequate because paragraph 1 Art. 241 of the RF Tax Code prescribes to determine the tax base and number of months from the beginning of the year.

When tackling aforesaid issues one should take into account accompanying risks. It must be noted here that the Tax Policy Department of the RF Ministry of Finance believes that the organization from the time of its reorganization calculates its tax base anew from the time of the completion of the reorganization process, summing up only such payments that were effected upon the reorganization completion. The position of arbitration courts is different from the one of the RF Ministry of Finance and implies that in order to calculate the tax base one shall use among other things information about the tax base for reorganized companies accrued starting from the beginning of the calendar year.

Tax consequences of the company's liquidation

When a company is liquidated tax payment obligations do not pass over to the company's successor. However, if a company is acquired only for the purposes of its future liquidation it appears feasible to do the audit of the company's tax liabilities as when it is declared that the company is going to be liquidated tax authorities may conduct audits both of the period that remains non-audited thereby before and already audited tax periods (within the term of three years).

Thus, in order to adequately appraise the company acquired for the future liquidation it is important that an actual volume of tax liabilities of such company be identified.

Profits tax

Under paragraph 2 Art. 277 of the RF Tax Code at the time of the company's liquidation and distribution of assets of the liquidated company the income of organizations – shareholders of the liquidated company are calculated "based on the market price of the property (proprietary rights) received thereby at the time of its receipt less (regardless of the form of payment) the value of said

company's shares actually paid by corresponding shareholders".

Subsequently, all assets remaining recognized in the balance sheet of the liquidated company upon the completion of settlements with creditors will be included in the income of participants based on their market valuation rather than on the book value of said assets. In such instance, the value of such assets will be reduced by the value of the liquidated company's shares paid by the shareholder.

Thus, if the value of the liquidated company's shares paid by the shareholders is below the market value of assets of the aforesaid company, the difference shall be included in the income of a shareholder.

When tax consequences of the company's liquidation are appraised, one shall take into account that its tax liabilities may increase not due to the disclosure of errors made in the course of the earlier calculation of taxes, but due to legitimate acts of a taxpayer as well. In particular, the liquidation of a company implies the inclusion of the following provisions in the company's income:

- For doubtful debts;
- For warranty repair works;
- For maintenance of depreciated fixed assets;
- For future vacations and remuneration payable for the annual performance.

Value Added Tax

VAT accrual

In accordance with subparagraph 5 paragraph 3 Art. 39 of the RF Tax Code the transfer of assets whose value does not exceed the cost of the initial contribution to a participant of any business entity (its successor or heir) is not deemed to constitute a sale of goods (works, services) when assets of the liquidated business entity or partnership are distributed between its participants.

In such instance, the aforesaid rule does not specify how the value of assets distribute in favor of the participant is calculated. For such purposes, in accordance with the principle of the universal will of the legislator formulated in paragraph 11 of Resolution No. 5 of the Plenary Session of the Supreme Arbitration Court of the Russian Federation dated February 28, 2001, one shall understand the way the value of assets is estimated as provided for in paragraph 2 Art. 277 of the RF Tax Code, i.e. one shall take into account the market value of distributed assets[1]. If the latter exceeds the cost of the participant's contribution, the total of such excess shall constitute an object of taxation for VAT purposes.

Under subparagraph 12 paragraph 2 Art. 149 of the RF Tax Code the sale of securities and shares in the authorized capital in the territory of the Russian Federation shall not be subject to taxation (tax exempt). Subsequently, if a participant receives shares owned by the liquidated company, their value exceeding the amount of the participant's initial contribution to the company's authorized capital shall not be subject to taxation (tax exempt).

The transfer of cash to a participant is not subject to VAT as provided in subparagraph 1 paragraph 1 Art. 39 of the RF Tax Code. Under the aforesaid subparagraph the transaction related to the circulation of Russian and foreign currency is not deemed to be a sale of goods, works and services.

Thus, if after the liquidation participants will receive cash and securities, their value is not going to be subject to taxation regardless of whether the value of transferred assets exceeds the amount contributed to the authorized capital or not.

Thus, in order to avoid VAT payments in the course of distribution of assets of the liquidated entity it is feasible to sell assets that are deemed to constitute an object of taxation for VAT purposes to a shareholder, and the balance of assets recognized in the balance sheet that are VAT exempt shall be distributed among the company's participants. VAT received at the time of sales shall be payable to the budget. However, a shareholder that acquired assets subject to VAT taxation from the liquidated company may make VAT paid at the time of the purchase of such assets deductible, if such assets are going to be used for the purposes of operations that are subject to VAT taxation (subparagraph 1 paragraph 2 Art. 171 the RF Tax Code). As a result, the gro-

[1] If any dispute arises and it is transferred for consideration to an arbitration court the latter shall act in accordance with rules regulating similar legal relations, as part 6 Art. 13 of the Arbitration Procedural Code of the Russian Federation prescribes in instances when "*disputable relations have not been expressly regulated by the federal law and other regulatory acts or an agreement reached by the parties and there are no customary business practices applicable thereto, if it does not contradict its nature, arbitration courts apply legal rules governing similar relations (analogy of law), and in the event of any lack of such rules one shall review cases based on general provisions and the essence of federal laws and other regulatory acts (analogy of law)*".

up will not incur any losses related to VAT payment.

VAT deduction and restoration of VAT amounts that were earlier made deductible

If a company transfers to a participant assets the value whereof is not subject to VAT taxation because the value of such assets does not exceed the amount of the initial contribution to the authorized capital, VAT paid at the time of the purchase of such assets:

- is not deductible, if by the time of such transfer the VAT was never made deductible;
- shall be restored and paid to the budget, if VAT on such assets was made deductible earlier. In such instance, in connection with depreciated assets only the part of VAT may be restored that is related to the under-depreciated portion of fixed assets, as only such portion of the value was not consumed at the time of execution of operations whereupon VAT is levied.

One may avoid the aforesaid VAT restoration utilizing the above method. Assets in connection with which VAT was paid, should be sold to a shareholder prior to the liquidation at the market value, and at the time of the liquidation one should distribute cash and assets generated from the sale in connection with which VAT was not paid. In such instance, VAT may not be restored, and if such VAT was not made deductible in connection with the aforesaid assets, the company does not lose the right to use such deductions. The buyer (shareholder) may make such VAT deductible that was paid to the liquidated company.

Tax consequences arising out of the inclusion of the company into a group of holding companies

Such variant implies that the holding organization owns stocks or other participatory shares in any other organization and does not transfer its assets and liabilities to its own accounts or accounts of any other holding company. Officially, a subsidiary (related) company operates as an independent company.

Inclusion of the company into a group of holding companies

The inclusion of the organization itself into a group of holding companies causes no tax consequences. Such consequences may arise only provided that a transaction with such company will be concluded within the group. In such instance, the price of the transaction may be controlled by both parties thereto from the standpoint of its compliance with the market value, and in the event of a difference of over 20% taxes may be recalculated on the basis of the market prices related to the transaction.□