Mergers and Acquisitions

Navigating Complexities Amid Changing International Tax Landscape

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Companies engage in mergers and acquisitions (M&As) for a myriad of reasons.

Greater synergies, enhanced supply chain, access to new markets and increase in market share are just some of the motivations for them. The Big Four accounting firms, for example, are all outcomes of M&As. Considering its many benefits, why is M&A not the default solution to every business problem? The reason is simple – engaging in an M&A deal can be risky for businesses.

While the fundamental concept of M&A (that is, the combination of two corporations to form one) is simple, M&A transactions can be complex and may adversely affect the business if not properly implemented. Amid the geopolitical uncertainties and fast-changing international tax landscape, it is now trickier than ever to pull off a "perfect" M&A transaction.

In particular, at a time when tax authorities around the world are stepping up their audits, buyers must be especially mindful of potential tax exposures when assessing their target companies. Tax warranties or tax deeds can be used where appropriate to mitigate their tax risks.

Reality Checks

In a typical M&A deal, much of the focus is on bringing two entities together. However, as in any contract, it cannot be said enough that consideration should also be given to possible exits in the future.

Given the level of risks involved in an M&A deal, it would be sensible for companies to think through their exit strategies even before undertaking the deal. Material demerger issues should be considered prior to the M&A deal in the event that the merger does not work out.

Besides being a way to get out of a failed merger, demergers are often used to unlock the cash value and to streamline the operations of the company to focus on its core business lines. Some companies may also use demergers as a way to reorganise their businesses and to refocus on the needs of a changing market.

Demerger agreements should generally state each party's responsibilities in handling tax and legal matters following the demerger (for example, tax audits or legacy legal suits).

What Can Go Wrong

Lack of understanding

An M&A is effectively a marriage between two companies, and like a marriage, the two parties must be compatible and have a good understanding of each other for the union to work. In an M&A deal, if the buyer acquires a target company without sufficient understanding of the latter's business (including the business model, product reach and marketing strategy), the target company may turn out to be a poor strategic fit for the buyer. Consequently, the buyer would not be able to achieve its business objective from the deal.

Disagreements in business direction

Post-merger disagreements between the two parties should be handled sensibly as they can derail the newly merged company following an otherwise successful M&A transaction. Both parties must put in every effort to work out their differences over the business direction to take, the business strategies to adopt or even the general management style, or risk crippling the company with these post-merger integration issues.

Differences in Work Culture

Different companies have different work cultures, and employees may sometimes find it difficult to adjust to the new environment following an M&A. For example, employees who are used to a people-oriented and collaborative culture may have a hard time fitting in to a result-oriented and competitive culture. Resistance to adopt the new work culture can have a negative impact on the overall performance of the company, as they may hinder the decision-making process and the ability for the company to operate effectively.

The M&A Journey

There are three key players in every M&A deal – the buyer, the target and the broker. Generally, the M&A journey begins with the buyer developing an acquisition strategy and defining its objectives for purchasing another company.

Upon defining its strategy and objective, the buyer would then search for potential target companies and conduct feasibility studies to ascertain whether a deal is commercially viable. Once the target company is identified, the buyer would perform due diligence on the target company and decide if it wishes to proceed with the deal.

Due Diligence

Unlike a feasibility study which determines commercial viability, due diligence is conducted for the purpose of eliciting comprehensive information about the target company, so as to assist the buyer in determining the purchase price. The information obtained from due diligence will influence the decision to negotiate, proceed or withdraw from the deal.

In an M&A deal, due diligence typically covers the tax, legal, commercial and financial aspects of the deal, among others.

Tax

Tax due diligence seeks to verify that the target company is compliant with the relevant tax legislations. Any potential tax liabilities (whether arising from non-compliance or ongoing disputes with the tax authorities) from open tax years should be quantified, and the buyer may then determine whether there is a need for tax warranties or tax deeds to mitigate its tax risks.

Tax due diligence is essential in determining the ideal financing model for the M&A deal. To decide on the level of debt to be used for the M&A deal, it is vital for the buyer to consider issues such as the tax treatment of loan instruments, restriction on interest deduction and existence of thin capitalisation rules in the country.

Tax structuring issues are also covered in tax due diligence. Red flags will be raised if the target's holding structure is unduly complex or channel profits to tax haven countries. Separately, the buyer should also take note if the target company's existing tax incentives are expiring and consider renewal possibilities.

Other areas typically covered in a tax due diligence include intellectual properties, management fees, technical services, withholding taxes, transfer pricing, repatriation of profits, indirect tax positions, as well as substantial change of shareholding (for the utilisation of unutilised tax losses).

Tax warranties are essentially statements indicated by the seller in the sale and purchase agreement covering tax issues. It serves to provide assurance to the buyer and provides remedy of compensation if the tax warranties are incorrect. The recovery of damages from tax warranties requires the buyer to prove loss. The buyer is also expected to take steps to mitigate its loss.

Unlike tax warranties, tax deeds generally cover unexpected tax liabilities. While the buyer does not need to prove loss or mitigate loss in the case of tax deeds, it is usually subject to certain exclusions and limits.

Barrister, Accredited Tax Advisor (Income Tax) Peter Tan, Senior Tax Advisor, Rajah & Tann Singapore, shared his insights on the potential impact of BEPS on M&A transactions.

Legal

Legal due diligence involves identifying and analysing potential legal risks associated with the target company. Typically, the buyer would examine the target company's legal compliance record with regulations, the legal ownership of the assets, any legal claims made against the target company, any unsettled employment disputes, as well as any other existing lawsuits.

Commercial

Commercial due diligence deals with various business issues such as identifying the type of deal (whether it should be share deal or asset deal), understanding the business model, determining the timing of the transaction, and deciding on the pricing.

Financial

Financial due diligence entails the analysis of the target company's financials, including the financial statements, performance forecasts, debtors and creditors, and any financial risks (such as foreign exchange risks).

The Changing M&A Landscape in the BEPS Era

The OECD's BEPS project has driven significant changes to the international tax landscape.

In a nutshell, BEPS is about the concern over the erosion of a country's tax base by shifting of profits causing the deprivation of tax revenue. To tackle BEPS, tax authorities have implemented a plethora of new tax rules in their respective countries. Increased transparency through exchange of information and greater scrutiny by tax authorities is now the name of the game.

BEPS has numerous impacts on M&A transactions, such as in the areas of permanent establishment, access to tax treaties and transfer pricing.

PERMANENT ESTABLISHMENT

The BEPS recommendations seek to prevent the artificial avoidance of permanent establishment status through commissionaire arrangements and specific activity exemptions (such as the fragmentation of activities and artificial splitting up of contracts to avoid falling within the permanent establishment rules).

In assessing an potential M&A deal, buyers must carefully consider the target company's operating model (for example, whether the target company uses commissionaire arrangements), and assess the risk of the target company unintentionally creating permanent establishments (and accordingly taxable presence) in different tax jurisdictions under the new permanent establishment rules.

Access to Tax Treaties

The multilateral instrument (MLI) is an agreement negotiated under the BEPS project. It serves as an overarching instrument to allow jurisdictions to swiftly amend their tax treaties to implement related BEPS recommendations.

As the MLI modifies the terms of existing tax treaties, it is vital that for the buyer to take into account the impact of the MLI in assessing its M&A deal. For example, the MLI may alter the availability of treaty relief for financing costs and accordingly impact the viability of the financing structure for the deal.

Post-acquisition, companies may also wish to review their legal, financing and operational structures in light of the MLI, to proactively manage potential impact.

Transfer Pricing

In line with the BEPS recommendations which seek to align transfer pricing outcomes with value creation, companies must ensure that their operational profits are aligned with the economic activities which generate them and that inter-company transactions are conducted at arm's length.

Transfer pricing adjustments can have serious financial impact. It is therefore essential for any tax due diligence to evaluate the target company's transfer pricing positions (especially in contentious areas like intangible assets) and ensure that contemporaneous transfer pricing documentation is available.

Barrister, Accredited Tax Advisor (Income Tax) Peter Tan clarifying queries posted by participants.

In the BEPS era, companies must be mindful of the tax exposures and risks when going on an M&A journey. While tax cannot be the sole driving factor for an M&A deal, it must always be carefully managed to ensure a successful M&A. The issues of permanent establishment, transfer pricing, legal ownership of assets and outstanding legal matters that may impact the merged entity are just some of the key matters to have a good grasp on, over and beyond the obvious financial and commercial issues, and not forgetting about the exit strategy (demerger) too.

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